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### Bankruptcy's Undiscovered Country

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## ACCEPTANCE REMARKS

### BANKRUPTCY'S UNDISCOVERED COUNTRY

*Douglas G. Baird\**

Tonight I shall talk about bankruptcy's past and its future. In doing this, I want to reconcile insights from two of our country's greatest philosophers. First, remember what Harry Truman told us:

*The only thing new in the world is the history you don't know.<sup>1</sup>*

But there is also Yogi Berra:

*The future ain't what it used to be.<sup>2</sup>*

To meet the challenges of the future, we must always look to the lessons of the past. The genius of our bankruptcy law lies in its ability to adapt itself to changing circumstances while respecting its two core principles: The fresh start for the honest but unfortunate individual debtor, and a second chance for a financially troubled, but fundamentally sound company to make it in the marketplace. To make sure we continue to do this, we must confront squarely an enormous challenge: The dramatic innovations in finance in recent years.

Individuals and corporations today can access capital in ways scarcely imaginable only a few years ago. When I was young, if you wanted credit, you had to put on a suit, go to your local bank, and fill out paperwork in front of an officious bank officer. Today, almost anyone can float securitized debt on global capital markets. Indeed, you can enter this market even if all you want to do is cover the purchase of a single cup of coffee at Starbucks. Just use a credit card. The financial revolution that has made this and much more

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\* Harry A. Bigelow Distinguished Service Professor of Law, University of Chicago Law School. These remarks were given at the *Emory Bankruptcy Developments Journal* annual banquet on March 27, 2008. I am grateful to the students of the *Journal* and most especially to Morris Macey who gave me a warm and gracious introduction. Morris has long been one of the great leaders of our profession and an exemplar of a person who has lived long and well in the law.

<sup>1</sup> MERLE MILLER, *PLAIN SPEAKING: AN ORAL BIOGRAPHY OF HARRY S. TRUMAN* 26 (1974).

<sup>2</sup> See Yogi Berra Official Web Site, <http://www.yogiberra.com/yogi-isms.html> (last visited Oct. 4, 2008).

possible is, over the long term, likely a good thing, but our job as bankruptcy lawyers will be in treating the casualties of this revolution, and there are going to be a lot of them.

### I. CONSUMER DEBT, TECHNOLOGY, AND THE AMERICAN DREAM

Let us start with consumer bankruptcies.<sup>3</sup> The number of bankruptcy cases doubled during the 1990s, but this is part of a much longer trend. The number of consumer bankruptcies also tripled in the 1950s, almost doubled in the 1960s, and tripled again during the 1980s. Only in the 1970s, a period marked by double-digit inflation, did the rate remain relatively flat. There is a simple explanation for this change: People are borrowing more—much more. The level of consumer debt has increased almost continuously from 1945, when it stood at \$5.7 billion, until the present day, when it approaches \$2 trillion.<sup>4</sup>

Default and bankruptcy are the inevitable consequences of borrowing. Holding everything else constant, as consumers borrow more, defaults increase, and bankruptcy filings rise. To state the obvious, we have more bankruptcies today because we have more debt. If there are no cars, there are no car accidents. If there is no debt, there is no bankruptcy. You increase the number of cars, and you get more accidents. You increase the amount of debt, and you get more bankruptcy.

A single engine is driving much of the change—and this returns me to my principal theme for the evening. Over the past sixty years, financial innovation has continuously transformed the consumer lending industry. It has become easier to borrow.

You lower the costs of borrowing, and people borrow more. This is a basic principle of economics: You make something cheaper, and demand for it increases. CDOs and all the exotic stuff you read about in the *Wall Street Journal* were dreamt up by a handful of investment bankers over Chinese food.<sup>5</sup> They are merely the latest innovations that make consumer credit ever more available.

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<sup>3</sup> This part of the paper draws on observations I made in Douglas G. Baird, *Technology, Information, and Bankruptcy*, 2007 U. ILL. L. REV. 305.

<sup>4</sup> See LENDOL CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* 291 (1999).

<sup>5</sup> See Mark Pittman, *Subprime Securities Market Began as 'Group of 5' Over Chinese*, BLOOMBERG NEWS, Dec. 17, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aA6YC1xKUoek>.

When people point to the huge rise in consumer debt as a cause for concern, their focus is usually on borrowing against future earnings to finance present consumption. Borrowing against future earnings to pay for present consumption on a large scale is a relatively recent phenomenon. My parents' generation, brought up during the Depression, would never dream of such a thing. In 1970, fewer than one in five American households had a credit card; now almost three households in four do. In 1970, credit card debt represented four percent of consumer borrowing; by 2002, it was forty-two percent.<sup>6</sup> American households today hold *untapped* credit lines worth more than \$4 trillion.<sup>7</sup>

Technology allows credit decisions to be made automatically with respect to ever smaller transactions. For many individuals—indeed now for the vast majority—the decision to smooth consumption is entirely a matter of personal choice. The markets have become incredibly liquid. Worry especially about overuse of this type of debt brought us BAPCPA. Such borrowing, however, is not necessarily bad.

Many of you have almost no current income but can anticipate, with considerable confidence, substantial future earnings. You will maximize your happiness over the course of your lives by consuming today against future income. You will make lots of money when you are fifty, but let's face it: By the time you are fifty, your life is over. The hormones are gone; you don't have fun anymore. Pizza and beer taste better at twenty-five than it ever will again. And so too for life's other pleasures. Borrow today from the person you will be when you are fifty. You might as well enjoy yourself now before it is too late.

But focusing on consumer debt distracts us from a bigger issue. Home mortgages represent more than seventy percent of all household debt. Living in one's own home is an integral part of the American Dream, and promoting home ownership has been for many years a widely lauded government policy. Home ownership, however, brings debt with it as surely as night follows day. In 1940, about forty-four percent of households owned their homes. In 2000, about sixty-six percent did. Moreover, the value of the houses has quadrupled

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<sup>6</sup> See WENDY EDELBERG, RISK-BASED PRICING OF INTEREST RATES IN HOUSEHOLD LOAN MARKETS 5 (Dec. 5, 2003), <http://www.federalreserve.gov/pubs/feds/2003/200362/200362pap.pdf>.

<sup>7</sup> DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING 89 (2d ed. 2005).

since 1940.<sup>8</sup> Another way to see the increasing importance of home ownership is to look at total mortgage debt relative to total household income. It was twenty percent of household income in 1950, forty-six percent in 1980, and seventy-three percent in 2001.<sup>9</sup> And the increase in home ownership—and with it the increase in borrowing to buy homes—has come from those with the highest credit risks.

In the press recently, it has been reported that there is a high level of fraud associated with subprime borrowing.<sup>10</sup> But this should not come as a surprise. History teaches that every time there is a new technology, opportunities open for the unscrupulous, and fraud will follow.<sup>11</sup> We have seen this in bankruptcy before, and we shall see it again. But fraud is not the main event.<sup>12</sup> It is the collapse in housing prices.

We must confront the following hard reality: New technology brought on a dramatic increase in borrowing by individuals who thought housing prices would not fall. The problem, as my colleague Richard Thaler reminds us, is that life is not like *Groundhog Day*. Unlike Bill Murray, we do not get the chance to live the same day (February 2nd) over and over until we finally learn enough to make all our choices perfectly. We do not have the chance to experiment with our own lives. Many important decisions—such as buying a house—are ones we do only a few times in our entire lives. We do not have rehearsals, and, for the most part, we do not have do-overs.<sup>13</sup>

We must rely on the experience of others, but this does not help us much when we confront a new market, one in which there are lending opportunities no one has seen before—adjustable rate, low down payment, no doc loans. Experience matters, and this is a place where no one has had enough of it. The

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<sup>8</sup> See Brian K. Bucks, Arthur B. Kennickell & Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FEDERAL RESERVE BULLETIN A32, Table 12 (2006), <http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf>.

<sup>9</sup> See Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 93 (Fall 2005).

<sup>10</sup> See, e.g., Christopher S. Rubaber, *Cases of Mortgage Fraud Up, FBI Says; Bureau Makes Issue a Priority*, WASH. POST, Mar. 8, 2007, at D4.

<sup>11</sup> See, e.g., *Cunningham v. Brown*, 265 U.S. 1 (1924) (Charles Ponzi defrauds thousands using bogus postal reply coupons.).

<sup>12</sup> Indeed, as Edward Morrison and I have argued elsewhere, what little evidence exists suggests that the level of fraud in bankruptcy has been declining. See Douglas G. Baird & Edward R. Morrison, *Adversary Proceedings: A Sideshow*, 80 AM. BANKR. L.J. 951 (2006) (challenges to discharge fell from about four percent during the early 1990s to about 1.5 percent in 2002).

<sup>13</sup> See Richard H. Thaler, *From Homo Economicus to Homo Sapiens*, 14 J. ECON. PERSP. 133, 135–36 (2000).

decline in housing prices we have seen in the last year is not something we have seen in decades. And even if you knew what happened in the past, you might be misled. There were many disadvantages to the old world, the one in which the mortgage sat in the bank that lent the money in the first place, but it was a simpler world. The relevant documentation was in one place, and if you wanted to restructure the debt, you knew who you had to bargain with. In the new world in which the debt itself is commoditized, the documentation could be anywhere. Foreclosing and proving up your claim is no longer going to be so easy. Moreover, working out a sensible restructuring may no longer be possible if the mortgage has been folded and repackaged multiple times. The costs associated with this restructuring may be a sound rationale for some of the reforms now in Congress. These would make it possible to strip-down home mortgage debt in Chapter 13 like other kinds of debt.<sup>14</sup>

Let us summarize then these observations about financial innovation and what it means for consumer bankruptcy. Home ownership has increased in large part because of financial innovation. The trajectory of change strongly suggests that the next round of consumer bankruptcies may be the worst since the Great Depression, but not because of irresponsible consumer borrowing. In the coming round of bankruptcies, we are going to have hardworking people whose only sin was to try to live the American Dream. Dealing with these honest, but unfortunate debtors will be one of the biggest challenges our consumer bankruptcy law has ever faced.

## II. CHAPTER 11'S NEW CHALLENGE

The same financial innovations that we have been discussing in the context of consumer bankruptcies will produce a new wave of challenges for business bankruptcies as well. We have allowed ordinary commercial loans to be sliced and diced and repackaged too. Defaults on these loans remain at record lows, but sooner or later, there will be a day of reckoning. Bankruptcy again can make the best of a bad situation. To get some purchase on this question, it is again useful to look at history.

Every account of Chapter 11 begins with railroads. The law of corporate reorganizations evolved out of the old equity receiverships used to reorganize

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<sup>14</sup> For an analysis of this idea, see Adam Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets*, (Georgetown Law & Econ. Res., Paper No. 1087816, February 6, 2008), available at SSRN: <http://ssrn.com/abstract=1087816>.

nineteenth-century railroads. Railroads like the *Atchinson Topeka & Santa Fe* turned an operating profit, but could not hope to recoup their construction costs, costs that ran into the hundreds of millions of dollars back when a hundred million dollars was real money. Their assets were being put to their highest and best use. Indeed, the iron rails and wooden ties connecting two cities had no use other than as a railroad.

There were but limited options for dealing with financially distressed railroads in the nineteenth century.<sup>15</sup> The prospect of a piecemeal sale—first left hand rails and then the right hand ones—was enormously destructive. But a cash sale of the whole business was simply out of the question. No single individual or group of individuals could amass sufficient capital. The law of corporate reorganizations came into being as a result. Lawyers and the investment bankers who sold the bonds in the first instance created it by extending the existing legal device of an equity receivership. Modern Chapter 11—with its automatic stay and its plans of reorganization and its absolute priority rule—derives its essential features from the equity receivership. But do we still have railroads? Perhaps not.

First, we need to worry less about destroying value through a piecemeal liquidation. In a service-oriented economy, the assets walk out the door at five o'clock. These businesses are fundamentally different from railroads. You can assemble and disassemble and outsource more easily. And I'm not just talking about sweaters and children's pajamas. Boeing's new 787 Dreamliner is being assembled in Seattle, but its components are being made elsewhere. Indeed, a third is from Japan.<sup>16</sup> New model Chevys have engines made in China.<sup>17</sup>

In addition, we now have many more winner-take-all markets. At work is something called the gazelle principle. You have a herd of beautiful gazelles that run across the African plain. Lions are their only enemy. Scientists have a special term for the really fast gazelle that is just a little bit slower than the others: Dinner! Today, a business venture may be unable to cover its expenses if the market provides an alternative way to make the same goods just a little bit cheaper. The businesses that fail today may be more likely to lack going-

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<sup>15</sup> See Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 758-60 (2002).

<sup>16</sup> See Peter Pae, *Japanese Helping 787 Take Wing*, L.A. TIMES, May 9, 2005, at C1.

<sup>17</sup> Ian Austen, *Under a Chevy's Hood, Some Innards from China and Japan*, N.Y. TIMES, Mar. 26, 2008, at D1.

concern value and cannot compete in the marketplace no matter how they are restructured.

Moreover, capital markets themselves have changed. Markets are far, far more liquid than they once were. When things go badly, you can have a market sale. In the equity receivership, no actual sale of the whole business could take place. Today, sales are part of the warp and woof of Chapter 11 practice. Indeed, the majority of large Chapter 11 cases end up as sales.<sup>18</sup> Sometimes the whole point of filing for Chapter 11 is to use the bankruptcy court as a way of selling their assets to the highest bidder, whether piecemeal or as a going concern. The bankruptcy judge has become auctioneer. In many other cases, a new owner comes into being simply by buying up the fulcrum securities. If we take a snapshot of the business before and after Chapter 11, we would not be able to tell whether there has been a Chapter 11 or a traditional corporate-control transaction.

The old shareholders are gone, as are the old managers and the old board; in addition, the business may be folded into another. New managers run a business whose operations have been streamlined and whose workforce has been reduced. The process itself resembles the takeover battles we see outside of bankruptcy. Corporate raiders square off against each other in a bidding war, just as they would in a hostile takeover. Lawyers shuttle between their offices in New York and a courtroom in Wilmington. Chapter 11 has morphed into a branch of the law governing mergers and acquisitions. But bankruptcy can change in this way and still be true to its core mission. The Code was not designed to put so much weight on § 363 going concern sales and we need to make sure that, if it is the right thing to do, we do it, and we do it well.

The dynamics I have just talked have been what we have seen in large Chapter 11s for the first half of this decade. What is financial innovation going to do to bankruptcy over the next few years? It is hard to say. Again to quote Yogi Berra:

*It's tough to make predictions, especially about the future.*<sup>19</sup>

But let us speculate. Let us start with some of the most obvious new kids on the block and how this is going to change things.

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<sup>18</sup> See Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675-77 (2003).

<sup>19</sup> See Famous Quotes and Quotations, <http://www.famous-quotes-and-quotations.com/yogi-berra-quotes.html> (last visited Oct. 4, 2008).

In 2001, second-lien loan volume was minuscule. By 2006, it was \$29 billion.<sup>20</sup> Now second liens are occupying large parts of the capital structure of many businesses, especially in the middle market. Companies are so highly leveraged with second liens that these cases are going to be administratively insolvent *from the start*. The trade creditors, the workers, the retirees are all out of the money from the get-go and everyone knows it. The Chapter 11 is exclusively for the benefit of secured creditors. They may well pay the workers and the trade, but only because they feel like it, only because it is in their self-interest.

Can the first- and second-lien holders come in to the bankruptcy court and say, "We would like you to do this reorganization for us. Don't pay any attention to the trade or the workers or anyone else but us. We understand that we need to fund the case to pay administration expenses and anyone else who can make nuisances of themselves, but that is what carveouts are for."<sup>21</sup> How are bankruptcy judges going to react when you appear and tell them they have to run a big Chapter 11 exclusively for the benefit of secured creditors?<sup>22</sup> If it is any comfort, this is not the first time we have seen this. The railroad equity receiverships were the same. The railroads were top-heavy with secured debt, and general creditors were entitled to nothing. Again, the only thing new in the world is the history you never learned.

There is another question I have about second liens. The intercreditor agreement is going to define the dynamics of the case.<sup>23</sup> When you have allowed a second lien, your first is only as good as your intercreditor agreement. We all know that second liens have gotten progressively less silent over time. And how vigorously negotiated was *your* intercreditor agreement? Let me ask the question this way. Did the same lawyer represent both the first- and second-lien holders in the deal? If so, you are depending on a deal your lawyer negotiated *with himself*.

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<sup>20</sup> See Gary D. Chamblee, *Reducing Battles Between First and Second Lien Holders Through Intercreditor Agreements: The Role of The New ABA Model Intercreditor Agreement Task Force*, 12 N.C. BANKING INST. 1 (Mar. 2008).

<sup>21</sup> For a discussion of carve outs, see Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445 (2002).

<sup>22</sup> See George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 24–25 (2004) ("secured creditors capitalizing upon agency problems to gain the help of insiders . . . the chapter 11 process and essentially create[d] a federal unified foreclosure process").

<sup>23</sup> See C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COMM. L.J. 189 (2006).

First-lien holders perhaps should not be sleeping so comfortably at night. The problem is not even what terms of the intercreditor agreement are, but rather how much wiggle room do they give the second lien holder. Maybe he has consented to the dip loan or has waived the right to object to the use of cash collateral, but is he really going to be stopped from making objections?

But there is yet another force at work that is especially scary. We are now going to be dealing with derivatives, credit default swaps, total return swaps, CLOs, and intricate capital structures all created by a twenty-eight-year-old physicist with absolutely no business experience. These devices turn the comfortable world we used to know upside down. The record owner you are negotiating with may have engaged in swap and derivative transactions such that, far from being long in the relevant position, he is short. You think you and he are working together trying to solve the firm's problems, but you are really negotiating with someone *who is better off if the firm blows up*.<sup>24</sup>

The credit default swap market now has a notional amount over \$60 trillion dollars.<sup>25</sup> We can have someone who is long or short the debt in a particular company by many times the amount of its total debt. I have been reassured by the people who do these deals that these new fangled derivatives will not create any problems for the bankruptcy system. They may be right. *And some day pigs may fly.*

And I haven't even begun to talk about claims trading here. Even if you aren't on the creditors committee, you have been knee-deep in negotiations from the get-go. You know all sorts of stuff that outsiders don't. How do you not have inside information? How can you trade? In recent years, we have seen the rise of so-called "Big Boy" letters. Just as the five-year-old seeking new responsibilities attests that he is a "big boy," so too an investor can give up any right he might have to complain that he was taken advantage of by signing a letter to the effect that he is a big boy willing to accept whatever risks come with nondisclosure.<sup>26</sup>

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<sup>24</sup> See Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008).

<sup>25</sup> For a discussion of how credit default swaps might change bankruptcy practice, see Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007).

<sup>26</sup> See Daniel Sullivan, *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533 (2008).

Do the securities laws allow this? Do the securities laws even apply? And if they don't, do bankruptcy judges have the power to regulate them?<sup>27</sup> Where would they get this power from? And what if you trade derivative instruments, not claims of the firm itself? How can you violate *any* fiduciary duties with respect to them? I do not know the answers to any of these questions.

#### CONCLUSION

In short, we are entering a brave, new world. This is the future of bankruptcy, its undiscovered country. In entering this unknown world, we should recall some of the most important lessons of the past. Bankruptcy law cannot make the imprudent wise and the unlucky fortunate. Nor can it insulate a poorly run business from the realities of the marketplace. Hence, the goals of bankruptcy are necessarily modest. Honest but unfortunate individuals should be given a fresh start. Corporations that have value as going concerns should be able to acquire a new capital structure, and those that cannot survive should be able to wrap up their affairs expeditiously. Bankruptcy law cannot work miracles, and more harm than good comes from seeking that which cannot be had. But if past is prologue, we can be confident that our bankruptcy system will rise to the challenges it is facing.

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<sup>27</sup> See Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569 (Winter 2002).

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