Efficient liquidation benefits creditors as a group.

Protection for Whom?

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Why does bankruptcy law exist? Whenever a law is set in place, we as citizens give up some of our freedoms and bind ourselves to actions that we might not otherwise choose. We do so willingly (at least in a collective sense) because we perceive that the benefits we will receive will more than offset the individual losses to our freedoms. To evaluate this tradeoff, we must clearly outline the problem that the law is intended to resolve.

Nonetheless, it may seem silly to question why bankruptcy law exists. After all, the answer appears obvious—a fundamental role of government in any society is to provide an effective mechanism for enforcing contracts. Even advocates of limited government (among which we would include ourselves) agree that private contracts are effective only to the extent that they can be enforced. To this end, civil courts regularly interpret and enforce a variety of private contracts, including labor contracts, loan agreements, lease agreements, and other performance contracts. Yet, most developed countries have special laws, with their own court systems, to address bankruptcy.

The complex web of details that ultimately determines the bankruptcy outcome for creditors and debtors ensures the execution of the pre-specified conditions contained in individual creditors' contracts and resolves any disputes that may arise in the process—nothing more than any civil court would accomplish. Moreover, it is common for creditors (and debtors) to seek legal recourse in civil courts rather than in bankruptcy court. Thus, bankruptcy law is redundant in this respect, as creditors have alternative venues for resolving defaults and other contractual disputes. So, we return to our fundamental question: Why does bankruptcy law exist?

Our particular interest is in business bankruptcy. Much of the public debate on bankruptcy appears to be based on the view that firms in financial distress simply require some breathing room in order to get their affairs straightened out so that they will be viable once again. This sentiment is succinctly summarized by the often-repeated statement that a firm has "sought bankruptcy protection from its creditors." Indeed, many corporations now appear to view bankruptcy simply as a financial management tool. Implicitly, if not explicitly, it appears that many assume that bankruptcy law is designed to protect debtors from their creditors.

In contrast, we argue that bankruptcy law is intended to protect creditors from one another. In the absence of a bankruptcy system, creditors generally find individual debt-collection remedies privately optimal, even though a coordinated liquidation would increase the total value of the firm's assets that could be distributed to the creditors as a group.

This idea is not new, although it is often ignored in policy debates. Legal scholars have long argued that bankruptcy law is a response to the "common pool" problem that arises when a firm with multiple creditors becomes insolvent. As Thomas Jackson writes in *The Logic and Limits of Bankruptcy Law:*

> The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors as a group when there are not enough assets to go around.

In other words, it would generally be socially desirable for

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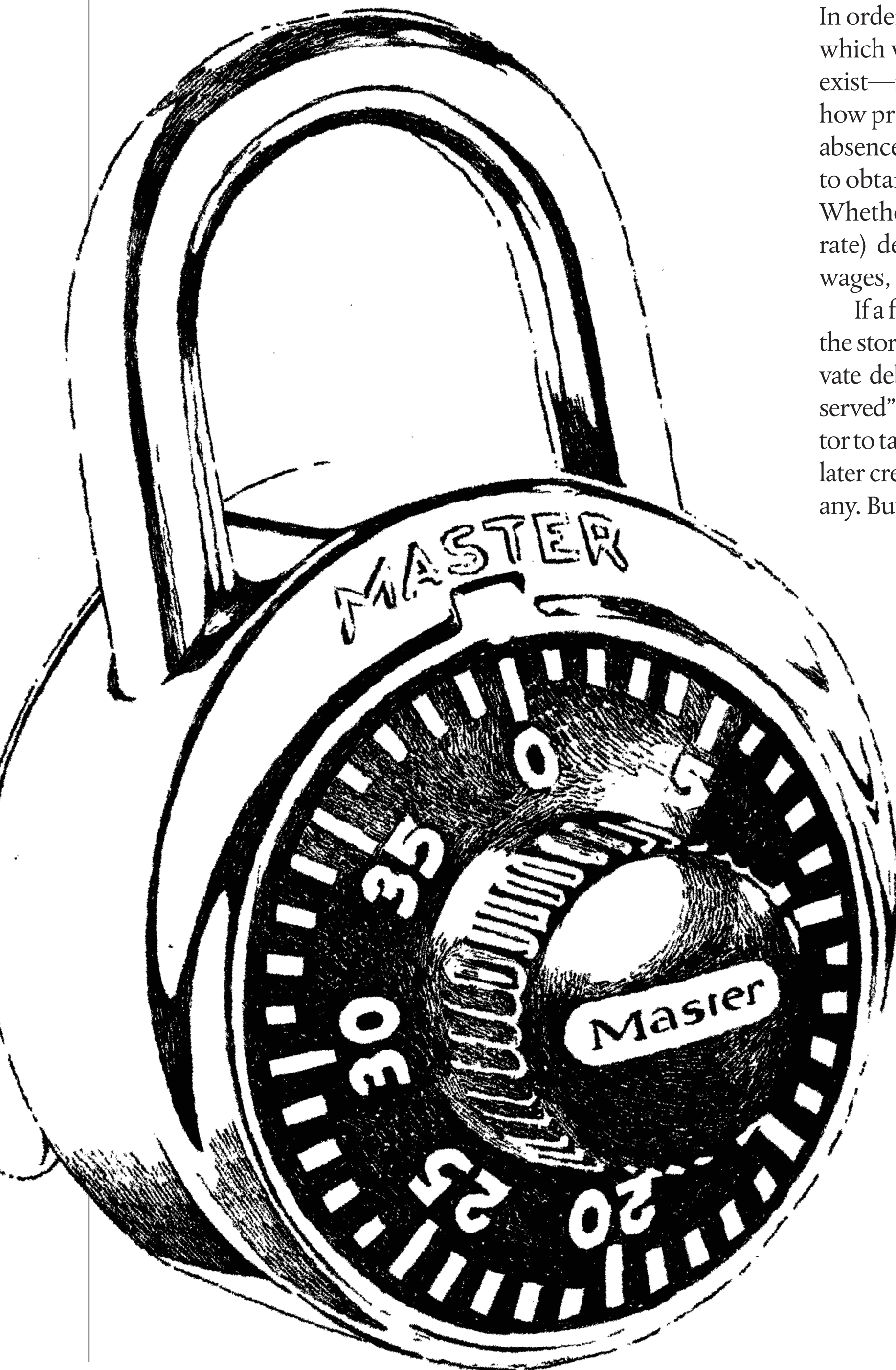
creditors to coordinate their debt-collection activities. This allows the debtor's assets to be deployed at their highest-value use, thereby increasing "the size of the pie" to be distributed. Nevertheless, in the absence of a bankruptcy law, once a debtor has reached insolvency, a creditor's most profitable course of action is to stake a claim on the debtor's assets that is sufficiently large to make it whole. Subsequently, other creditors become aware of the debtor's troubles and file their own claims without regard to the impact on other creditors. This can trigger an inefficient liquidation because the debtor's assets are sold off in an ad hoc manner. A bankruptcy law that mandates a collective process avoids this inefficient liquidation.

Although the reasoning is compelling, this justification for bankruptcy is incomplete on its own. In particular, the argument does not explain why creditors do not write contracts up front that bind them to coordinate with one another once the firm becomes insolvent. Some have argued that it is simply too costly for "coordination contracts" to be written, especially when the firm has many creditors. This argument implies that if the transaction costs were low enough—if market frictions were absent or if there were but a few creditors—contracts mandating coordination would be voluntarily written by the firm's creditors. In contrast, we argue that creditors will generally choose not to write contracts that effect coordination, even in the absence of transaction costs. In other words, the coordination problem among creditors arises not because creditors are unable to contract around it, but rather because they are unwilling to do so.



MORGAN BALLARD

A WORLD WITHOUT BANKRUPTCY

In order to explore this proposition, we play a mental game in which we imagine a world in which bankruptcy law does not exist—in economists' jargon, we build a model—and then ask how private parties would behave in such a world. Even in the absence of bankruptcy law, creditors can file a civil suit in order to obtain repayment when a debtor defaults on its obligations. Whether it be by granting the creditor a claim on the (corporate) debtor's assets or garnishing the (individual) debtor's wages, a civil court enforces the private debt agreement.

If a firm has only one creditor, this private action is the end of the story. When a firm has multiple creditors, however, this private debt-collection process develops into a "first-come, first-served" feast on the firm's assets. In other words, the first creditor to take action against the firm will be the first to obtain relief; later creditors will gain possession of whatever assets remain, if any. But the key is that no creditor thinks about preserving the value of the debtor's assets for subsequent creditors.

When a creditor rushes to exact its "pound of flesh" before the others arrive, the debtor's assets may be liquidated in a way that does not ensure they are deployed at their highest-valued use. For example, certain combinations of the debtor's assets may fetch higher valuations than others; manufacturing equipment may be sold at a higher price as a unit than if each piece is sold separately. Similarly, the order in which assets are sold can affect their value—the execution of a creditor's claim on a debtor's warehouse may force its contents to be sold at fire-sale prices; machine tools or production equipment might be prematurely sold to meet an individual creditor's claim, leaving for the rest of the claimants poorly functioning machinery or inventories of partially completed products.

If creditors could coordinate their liquidation activities, they could ensure that the debtor's assets are deployed efficiently, thereby increasing the size of the pie to be divided among them (and the debtor, if the pie is big enough). In spite of this, creditors will typically choose to pursue unilateral debt collection remedies, operating under the premise, "If I get my piece of the pie first, who cares if the others only get crumbs?" The problem with this approach is that there is no guarantee as to which creditor will be first.

Although in some instances in this game a creditor may turn out okay by seeking unilateral repayment of its loans, on average each creditor receives less from this behavior than it would by coordinating debt-collection efforts with the others.

Remember that we are imagining how the firm and its creditors would behave if no bankruptcy law exists. The choice each creditor faces is simple: It must figure out whether it would lose more from an inefficient liquidation than it would lose to another creditor if it coordinated its debt-collection efforts. When coordination fails to occur in this game, it is most often the small creditors that are responsible. Because of their relatively small size, it is less likely that their claim will be impaired by the cost of inefficient liquidation. At the same time, because other creditors hold the bulk of the firm's debt, a small creditor will receive relatively little in a coordinated liquidation. As a result, small creditors are most likely to have incentive to pursue private debt collection efforts instead of coordination.

In fact, as the number of creditors increases, ex post coordination will be harder to obtain. With many creditors, it is more likely that some will be small relative to the firm's total debts, allowing them to take a bite out of the debtor's assets without cannibalizing their own claims.

CONTRACTS TO THE RESCUE? Given that a unilateral liquidation of the firm entails deadweight losses, it would seem that everyone would benefit from writing contracts that effect coordination. In particular, it might be possible for each creditor to include an enforceable "coordination clause" in its loan agreement mandating that, in the event of insolvency, it will attempt to coordinate its liquidation actions with other creditors. It is important to note that such a clause would not force other creditors to coordinate. After all, the other creditors are not party to the contract. Rather, the clause would prevent the creditor who agrees to it from pursuing independent debt-collection activities.

No creditor would want to bind itself in this way unless it is confident that other creditors will do so as well. After all, why would I want to promise to work together with you if I am the first to discover problems with our common debtor, only to let you leave me behind if you are the first to discover the problems? Furthermore, even a creditor that is certain that the others have used coordination clauses (perhaps because the other creditors' contracts are already in place) will not use one itself whenever the losses associated with an inefficient liquidation are less than what the other creditors would receive in a coordinated liquidation. Simply put, each creditor asks itself the question, "Will I give more to the other creditors when I coordinate than I would destroy by pursuing debt collection on my own?" If the answer is yes, the creditor's loan agreement will not include a coordination clause, even though such clauses would be beneficial to everyone concerned.

Although private contracting cannot resolve creditor conflict problems in all cases, it can in some. As mentioned above, large creditors have more to fear from an ad hoc liquidation of the firm's assets because they are more likely to bear its deadweight cost. Thus, when the first creditor to contract with the firm is relatively small, it will be less concerned about being exploited by a later (larger) creditor and hence more willing to commit to coordination.

> A creditor must figure out whether it would lose more from an inefficient liquidation or from coordinating with other creditors.

On the other hand, when the firm's first creditor is large (as is often the case for small businesses that first obtain a bank loan and then engage other small creditors), up-front contracting is wholly ineffective in resolving creditor conflict. By fixing the terms of its contract with its largest creditor first, there will be strong incentives by future creditors to exploit the contract.

It is important to emphasize that contracting costs are not the impediment to the use of coordination clauses. Instead, the root of the contracting breakdown is a type of problem known to economists as "time inconsistency." Because the first creditor's contract is fixed by the time later creditors write their contracts with the debtor, the later creditors will choose contracts that exploit the early one, thereby allowing them to offer the debtor the lowest possible interest rate. Early creditors anticipate this behavior and write their contracts accordingly. Thus, although creditors are able to write contracts that mandate coordination, they nevertheless choose not to.

Notice what happens here. Even though all creditors would prefer that coordination take place should the firm become insolvent, they will refuse to write contracts up front that would ensure that this occurs. As a result, a bankruptcy system that mandates such coordination makes all parties better off. This result goes beyond the observations among legal scholars because it argues that creditors will choose not to write contracts that will resolve the creditor conflict, even when doing so is costless.

So what does our mental exercise teach us about bankruptcy law? Whatever else it might entail, any effective bankruptcy system must incorporate two fundamental features:

- The bankruptcy procedure must prevent creditors from pursuing independent debt-collection activities. That is, it must impose an automatic stay.
- The procedure must mandate the return of payments made to creditors just prior to the public discovery of the firm's

insolvency. That is, the bankruptcy system should enforce preference provisions.

In short, the underlying rationale for the existence of bankruptcy law requires that it be both compulsory and collective.

COVENANTS, SENIORITY, AND COLLATERAL

Can other common contracting devices resolve the creditor conflict without requiring the use of a mandatory bankruptcy system? We can imagine three such contracting devices: covenants, seniority, and collateral. While each of these has the potential to induce coordination, they do so only in special cases and only at a cost.

COORDINATION COVENANTS One potential solution is for early creditors to include "coordination covenants" in their loan agreements. A coordination covenant stipulates that the creditor's loan agreement will be in default unless other creditors' contracts include the coordination clauses outlined above. Recall that U.S. law does not allow covenants to impose coordination on subsequent creditors. Instead, this covenant allows the creditor to call its loan should it learn that a non-coordinating contract was written with a later creditor. A creditor's ability to enforce coordination through this covenant requires "monitoring" the debtor's subsequent contracts. Thus, covenants are rationally used by creditors only if the cost of monitoring subsequent creditors' contracts is perceived to be less than the expected loss associated with an ad hoc liquidation.

Although coordination clauses can achieve coordination in some circumstances, in many instances they would prove too costly and would not be used. Even if coordination covenants are used, the monitoring of the covenants is costly, leading to an outcome that is less than ideal. A bankruptcy law that mandates that creditors coordinate with one another would avoid this costly monitoring effort, benefiting everyone.

SENIORITY FOR EARLY CREDITORS Another contractual device that might induce lenders to coordinate is priority. One such priority assignment would be to grant the firm's first creditor seniority over the firm's assets. Thus, if the firm is liquidated, its assets would be used to repay the creditor in full before anything is paid to the firm's other lenders. This is simply the "me-first" rule described by Eugene Fama and Merton Miller. This priority structure arises out of a creditor's desire to protect its claim from dilution by subsequent creditors. Granting the first creditor seniority over the firm's assets limits later creditors' ability to expropriate value from the first creditor's claim.

Ultimately, however, priority for either creditor is meaningless unless coordination is achieved. If later creditors do not agree to coordinate, the first creditor's senior position provides it no protection. This is because "seniority" is not enforceable per se; creditors may voluntarily subordinate themselves, but cannot have this junior status forced upon them without their consent. The unenforceability of "covenant priority," as the seniority covenant is often called, makes the senior creditor vulnerable. The seniority covenant simply places the creditor's loan in default if a subsequent creditor does not subordinate. In order to ensure its senior status, the senior creditor must monitor all subsequent loan contracts. But this is the same problem that existed with coordination covenants. As a consequence, the outcome of the process is the same whether the first creditor uses a coordination covenant alone or uses it in conjunction with a seniority covenant.

SENIORITY FOR THE SECOND CREDITOR The other possible way that seniority might influence coordination incentives is for the first creditor to subordinate its claim (and include a coordination clause) to that of later creditors. Because the creditor's loan agreement is written before the firm contracts with any other lenders, its commitment to coordinate is credible. Furthermore, because it has taken a junior claim, it is impossible for the firm and later creditors to put it in a disadvantaged position by refusing to write coordination clauses in their loan agreements. Notably, later creditors have more incentive to coordinate when they have seniority because they must be paid in full before the first creditor will receive anything. As a result, contractual terms that make the later creditors senior to early creditors will always achieve coordination.

However, there is a significant incentive problem with this resolution. If the first creditor subordinates its claim, it opens itself to actions by the firm and later creditors that could decrease the value of its debt. This is commonly known as the "debt dilution" problem. In fact, the "me-first" rule described by Fama and Miller was intended to resolve this debt dilution problem.

To see the nature of this problem, imagine that the first creditor's loan finances an initial project, and that a later creditor's loan finances a follow-up project. If the first creditor subordinates, the second creditor may allow the firm to increase its debt-to-total assets ratio with the new project, thereby increasing the chance of default. Alternatively, the second creditor may allow the firm to undertake a more risky project, once again to the detriment of the original creditor. The root of this problem lies in the fact that the second creditor's priority gives it first claim on the firm's assets, including the firm's existing assets (i.e., those assets financed by the first creditor's loan), rather than only the portion of the firm's assets financed by that creditor.

Anticipating this behavior, the first creditor will either refuse to accept a subordination clause or will charge the borrower a premium adequate to compensate for the subsequent moral hazard. Clearly in the former case, coordination will not occur; in the latter case, it will occur if and only if the creditors' debt is cheaper after accounting for the debt dilution than it is accounting for the cost of an inefficient liquidation.

In sum, giving later creditors seniority can resolve the creditor conflict problem, but only in special cases and only at the expense of higher borrowing costs from debt dilution problems. The last out to this contracting dilemma, to which we turn next, is collateral.

SECURITY INTERESTS A perfected security interest in the debtor's assets is a legal claim that cannot be made subordinate to a future creditor's claim. This is commonly known as collateral. It can provide a means of credibly committing creditors to coordinate their liquidation activities because no creditor can subrogate the secured claim by pursuing independent debt-col-

lection activities. In other words, collateral does not suffer from the same time-inconsistency problem as covenants because a lien is enforceable after the fact.

Collateral functions differently than other subordination mechanisms. Importantly, creditors do not secure a dollar value of the firm's total assets, or even a particular fraction of this value. Rather, a security agreement gives the creditor first claim on the specific assets that were used to collateralize the debt. In order to perfect the security interest—to make it legally binding in civil courts—the creditor must file a financing statement that includes a description of the assets that serve as collateral. The public nature of this filing ensures that future creditors can be fully aware of the conditions under which they can expect repayment of their loans, thus avoiding the notification problems with the more general "seniority clauses" discussed above.

Although security agreements must clearly identify the assets to be collateralized, in practice this description may be fairly general. For example, agreements creating a security interest in "all of the firm's manufacturing equipment, both currently in place and obtained in the future" or "all funds deposited on account with Bank X" would be enforceable against other creditors ex post. Thus, it is in principle possible for the first creditor to file a series of financing statements that would cover essentially all of the firm's tangible assets, effectively giving an early creditor the same protection as a blanket seniority clause that could not be enforced otherwise. This complete seniority for the first creditor would obviate the need for a mandatory bankruptcy law; if the first creditor is always able to enforce its claim against other creditors that might choose to liquidate assets in default, all creditors would have an incentive to coordinate their liquidation activities.

Despite the fact that fairly general descriptions may be used to identify the assets backing a claim, many of the firm's assets will be unsuitable to serve as collateral for its debt. For example, intangible assets and growth opportunities cannot in general be identified with any specificity, and therefore cannot be used to protect an early creditor's interests. In many industries, such as biotech, pharmaceutical and the Internet, these intangibles can often constitute the bulk of a firm's assets.

Furthermore, assets that can be misused, neglected, or absconded with will not be good candidates for collateral. Although a creditor may be able to clearly identify bank accounts and other liquid assets in a financing statement, to the extent that the firm uses the funds during the regular course of business, it may be able to redirect them to the detriment of the secured creditor. Similarly, even when the firm's inventories serve as collateral for one creditor, it will be difficult in practice to prevent the firm from selling off the inventories at a discount and using the proceeds to pay off another creditor that is demanding repayment on its loan.

This problem will be mitigated if the secured lender can sue unsecured creditors to recover such preferential payments. But in the absence of an automatic stay on the unsecured creditor's debt collection efforts, it may be difficult after the fact to trace the line between the disposal of the assets serving as collateral and the payments made to the unsecured creditors. Thus, even collateralized claims depend on the basic elements of a bankruptcy system—the automatic stay and preference provisions—to ensure effective protection for the secured creditor.

There are private actions a secured creditor might take to protect its interests, even in the absence of a bankruptcy system with these provisions. For example, it may impose restrictive covenants on the firm's use of any assets serving as collateral, requiring prior approval before they may be liquidated. Restrictions such as these, however, may prove more costly than they are worth. By limiting the firm's ability to misuse the assets, the creditor may also hamper the firm's ability to redirect the assets to their highest-valued use. In other words, the very restrictions the creditor may require to protect its own interests may limit the firm's ability to maximize its profits. Furthermore, covenants restricting the use of collateralized assets must be monitored if they are to be effective in protecting the secured creditor's interests. Consequently, secured debt may be no more effective in reducing the costs of coordination than seniority and coordination covenants.

Although collateral may result in coordination in some cases, it cannot serve as a general replacement for a bankruptcy system that mandates creditor coordination. Thus, our primary conclusion is reconfirmed: A mandatory bankruptcy law that ensures all creditors will coordinate their liquidation activities in default improves social welfare relative to private contracting solutions.

CONCLUSION

Once a debtor becomes financially distressed, conflict among creditors can occur, leading to an inefficient liquidation of the debtor. In the absence of a bankruptcy law, when a debtor's liabilities exceed its assets, creditors will often have private incentives to pursue independent debt-collection activities, staking claims on the firm's assets. The resulting ad hoc liquidation of the assets necessary to meet individual creditors' claims leads to deadweight losses when compared to a coordinated liquidation.

This problem can exist even when the firm and its creditors can anticipate the conflict and costlessly write enforceable clauses into their contracts committing themselves to coordinate their liquidation activities. This failure occurs because creditors contract with the firm at different points in time. Once the terms of an early creditor's contract are determined, neither a future creditor nor the debtor has the incentive to write a coordination clause into the loan agreement.

In addition, we have argued that other private solutions, such as coordination covenants, seniority covenants, and security interests, offer only limited success in enhancing incentives to include coordination clauses. On that basis, we argue that a bankruptcy law is socially desirable because it forces creditors to commit to the very behavior to which they would like to have committed in the first place.

This conclusion has an important implication for public policy. Michael Jensen, among others, has suggested that market-based auctions would provide a superior resolution of insolvency because they would ensure an efficient allocation of resources once bankruptcy occurs. Such a conclusion is often interpreted as an indictment of existing bankruptcy law in favor of market-based solutions. We have argued that cred-

itors will generally choose liquidation procedures that are privately optimal (involving "runs" on the debtor's assets) rather than socially efficient (involving a coordinated liquidation like an auction). Furthermore, creditors' lack of incentive to contract around this problem suggests that even under private, market-based resolutions to insolvency, a mechanism must exist that will prohibit creditors from opting out of the procedure to pursue their own debt collection remedies.

At this point, the astute reader has likely grown impatient with the fact that we have ignored the costs of administering a bankruptcy system. If such administrative costs outweigh the social gains we have described, then private debt collection remedies will be preferable, despite the deadweight costs they entail.

Regardless of whether or not a bankruptcy law exists, however, the liquidation of a debtor's assets is costly. The costs can be attributed to three separate aspects of a liquidation: the cost of valuing the assets, the cost of distributing the assets, and the cost of inefficiently deploying the assets. It is this third cost that a mandatory bankruptcy system can minimize.

What about the first two administrative costs? Those costs—the valuation and distribution of assets—are likely to be minimized if liquidation is handled in a coordinated manner, regardless of whether such coordination is effected through private contracts or a public bankruptcy procedure. The reason is that a coordinated liquidation avoids a costly duplication of those tasks.

Bankruptcy law is designed to achieve one primary purpose: to coordinate the debt collection activities of a firm's various creditors. To that end, we suggest that basic bankruptcy laws would include provisions such as the automatic stay and the return of payments made to creditors on the eve of bankruptcy (preference provisions) as mandated in the U.S. bankruptcy code. More specific questions such as how to administer negotiations during a reorganization or whether violations of priority should be permitted, for example, are beyond the scope of our arguments here. R

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