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THE NEW RAWLSIAN THEORY OF BANKRUPTCY ETHICS

*Mary Josephine Newborn**

Bankruptcy . . . for most academics, probably ranks somewhere between the classification of Etruscan tombs and the life cycle of the sheep liver fluke. The wonder is that it has any fancy doctrine at all.[1]

I. INTRODUCTION

Bankruptcy law was once considered a rather insular sub-specialty of commercial law. Bankruptcy scholars of an earlier time devoted their energies to drafting bankruptcy legislation, mastering its particulars, and systematizing the case law.[2] When these scholars attempted to locate larger themes in bankruptcy, they labored with great deference to positive expressions of bankruptcy's purpose.[3]

Bankruptcy law's insularity began to fade with, among other things, the innovative work of Professor Thomas Jackson.[4] Instead

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1 John D. Ayer, *So Near to Cleveland, So Far from God: An Essay on the Ethnography of Bankruptcy*, 61 U. CIN. L. REV. 407, 415 (1992).

2 *See, e.g.*, *id.* at 408-11.

3 Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1 (1940); Garrard Glenn, *Essentials of Bankruptcy: Prevention of Fraud, and Control of Debtor*, 23 VA. L. REV. 373 (1937); *see also* Report of the Commission on the Bankruptcy Laws of the United States, H.R. DOC. NO. 137, 93d Cong., 1st Sess. (1973) ("Few if any jurisprudential schools or philosophical systems attempt to explain the position of the bankruptcy process in the legal order."). For a rare and early attempt to outline a philosophical approach, see Philip Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 UCLA L. REV. 403, 463 (1973) (likening bankruptcy to " 'act' utilitarianism").

4 There is no doubt that the soaring number of bankruptcy petitions also contributed to bankruptcy's emergence from obscurity. The number of bankruptcy petitions filed nationwide has steadily increased: from July 1988 to June 1989 there were 642,933; from July 1989 to June 1990 there were 725,484; and from July 1990 to June 1991 there were 880,339. *1 M. Filings Expected in '91*, 21 Bankr. Ct. Dec. (CRR), Sept. 19, 1991, at A7, A7 (citing figures from the Administrative Office of the U.S. courts). The number of filings has increased steadily since 1984. *See* Karen Gross, *Re-Vision of the Bankruptcy System: New Images of Individual Debtors*, 88 MICH. L. REV. 1506, 1512 n.18 (1990) (reviewing TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS (1989)); Susan Moffatt, *Record Number of Bankruptcies in 1991 Forecast*, L.A. TIMES, Sept. 5, 1991, at D1. *See generally* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON

of trying to discern bankruptcy's purpose from the text of the Bankruptcy Code ("the Code") or from judicial opinions interpreting the Code, Jackson sought a comprehensive theoretical explanation for bankruptcy's existence. His explanation for bankruptcy was based, in part, on a contractarian paradigm called the "creditors' bargain."[5] According to this paradigm, bankruptcy reflects the bargain that creditors themselves would strike *ex ante* if they negotiated privately to draft a bankruptcy system.[6] Creditors would agree to a collective and compulsory system that tended to result in increased assets.

Several bankruptcy scholars have challenged the creditors' bargain model.[7] In particular, Professor Elizabeth Warren charged

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BANKRUPTCY 39-43 (2d ed. 1990) (arguing that the debtor/multiple creditor relationship results in a common pool problem; therefore, in the absence of information, creditors would agree to pro rata sharing to preserve the benefits of collective actions in liquidating the debtor's estate); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 28-31 (1986) [hereinafter JACKSON, LOGIC AND LIMITS] (discussing the common pool problem in the context of what problems a bankruptcy system should and should not concern itself with); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725 (1984) (discussing the common pool problem in the context of why the various avoiding powers exist in bankruptcy); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) [hereinafter Jackson, *Bankruptcy and the Creditors' Bargain*] (discussing the common pool problem in the context of distributional priorities in bankruptcy).

[5] Jackson, *Bankruptcy and the Creditors' Bargain*, *supra* note 4, at 858.

[6] *Id.* at 860. At this point, even the reader who knows very little about bankruptcy could guess that Jackson's highly abstract model contained several unrealistic assumptions and therefore might not be able to explain much of bankruptcy law. Jackson responded to this criticism by revising his original creditors' bargain model to account for what he called "persistent and systematic redistributional impulses . . . apparent in bankruptcy." Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 156 (1989) (suggesting that creditors might adopt a loss sharing formula like the general average in admiralty because they are risk averse). Although Jackson's expanded creditors' bargain theory also attracted its share of critics, it has not attracted as much attention as the original. *But see* David G. Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 457 (1992) [hereinafter Carlson, *Bankruptcy Theory*] ("[T]he expanded creditors' bargain . . . model makes few, if any, improvements, on the old model, even while covertly changing most of its original premises.").

[7] One of the earliest critics was Professor Vern Countryman. *See* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713 (1985) (questioning the assumption that all creditors strike a bargain on the basis of equal information and greed). For more recent criticism, see Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) (arguing that the common pool problem is illusory); James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2111-13 (1990) (arguing that the creditors' bargain model is theoretically flawed because it assumes "debtor passivity"); Robert K. Rasmussen, *Bankruptcy and the Administrative State*, 42 HASTINGS L.J. 1567, 1568 (1991) ("[The creditors' bargain model] relentlessly reduces all disputes between a debtor and its creditors to the private law paradigm of

that it was too narrow a construct upon which to rest the complex and contradictory loss allocation impulses that permeate multiple defaults.[8] Professor David Gray Carlson strongly asserted that the creditors' bargain was riddled with highly questionable assumptions and irreconcilable contradictions.[9] Although criticisms of this sort tarnished the creditors' bargain model's luster, a direct theoretical challenge to the economic account was slow to emerge.

Professor Donald Korobkin has offered such a challenge. In several recent articles, Professor Korobkin has presented a nascent theory of bankruptcy based upon what he calls a "value-based account" of bankruptcy.[10] In his latest work, Professor Korobkin has buttressed his value-based account with a highly theoretical contractarian model of his own: the "bankruptcy choice model."[11] The bankruptcy choice model is based, in part, on the hypothetical choice situation developed by the political philosopher John Rawls in *A Theory of Justice*.[12]

This Article explores Korobkin's latest contribution to "fancy doctrine" in bankruptcy scholarship. Part II of the Article commences with a review of the economic account and its major critics. The Article then discusses Korobkin's value-based account of bankruptcy and the bankruptcy choice model. Korobkin posits that those in the bankruptcy choice model would select two principles to govern relationships in financial distress: (1) the "principle of inclusion";[13] and (2) the "principle of rational planning."[14]

Before critiquing these principles, Part III explores two preliminary questions. First, why do these principles differ from the principles that the parties in the original creditors' bargain might select? Second, what do these principles contribute to our understanding of bankruptcy law? This examination reveals that the

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a private creditor suing the debtor."); Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 337 (1989) (criticizing Jackson's narrow premise).

8 Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987) [hereinafter Warren, *Bankruptcy Policy*].

9 David G. Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341 (1987) [hereinafter Carlson, *Philosophy*] (reviewing THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986)); Carlson, *Bankruptcy Theory*, *supra* note 6.

10 Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 721 (1991) [hereinafter Korobkin, *Rehabilitating Values*]; *see also* Donald R. Korobkin, *Value and Rationality in Bankruptcy Decision Making*, 33 WM. & MARY L. REV. 333 (1992).

11 Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541 (1993) [hereinafter Korobkin, *Contractarianism*].

12 JOHN RAWLS, A THEORY OF JUSTICE (1971).

13 Korobkin, *Contractarianism*, *supra* note 11, at 545.

14 *Id.*

principles of inclusion and rational planning differ from other "first principles" because they proceed from different assumptions about representation, knowledge, and motivation. While the parties in the original creditors' bargain are self-interested, wealth-maximizing contract creditors, the parties in the bankruptcy choice model are ignorant, self-interested persons seeking to promote their own aims, whatever those aims turn out to be. These different conceptions of the choice situation result in a perspective on bankruptcy law that is more complete than previous accounts. Additionally, these principles contribute descriptive and analytical insights to our understanding of bankruptcy law. However, the principles also suffer from substantive vagueness and indeterminacy.

Part IV of the Article thus returns to the bankruptcy choice model and examines its essential features in more detail. Indeed, as Korobkin states, "[t]he construction of the model is thus crucial: a contractarian account of bankruptcy is only as compelling as the hypothetical model on which the account is founded."[15] Part IV reveals that Korobkin's model contains several controversial assumptions that seriously undermine the claim that these principles are chosen under proper conditions, and thus calls into question whether the bankruptcy choice model is even capable of successfully guiding bankruptcy policy.

The Article concludes with some thoughts on the Article's implications for the role of "fancy doctrine" in bankruptcy scholarship.

II. "Fancy Doctrine" in Bankruptcy Scholarship

A. *The Economic Account and the Original Creditors' Bargain*

Professors Thomas Jackson and Douglas Baird are credited with developing what Professor Korobkin has called an economic account of bankruptcy law.[16] This theory proposes that bank-

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15 *Id.* at 553.

16 Korobkin, *Rehabilitating Values*, *supra* note 10, at 718. The efforts of Jackson and Baird should not be confused with the popular, yet controversial work of Professors Michael Bradley and Michael Rosenzweig. *See* Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992). Professors Bradley and Rosenzweig argue that Chapter 11 should be discarded in favor of a federal rule that cancels residual ownership interests immediately upon default. The work of Professors Bradley and Rosenzweig has prompted a vigorous debate on the wisdom of Chapter 11. *See* Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465; Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992);

ruptcy's central purpose is debt collection.[17] However, we already have state systems for debt collection. What, then, justifies our having a distinct bankruptcy system? The economic account explains that a system of individual creditor's remedies may be suitable when the debtor has sufficient assets to satisfy all creditors. However, when the debtor is insolvent, a system of individual creditor's remedies will have deleterious effects on creditors as a group.[18] This situation exists because of the diverse ownership interests that participate in most bankruptcies.[19] Diverse owners have an incentive to work at cross-purposes to enforce their rights. Thus, bankruptcy provides a way to make these "diverse [owners] act as one, by imposing a *collective* and *compulsory* proceeding on them."[20]

Why *should* these diverse owners act as one? Jackson and Baird explain that a key normative aim of the economic account is asset maximization.[21] The economic account suggests that bankruptcy law should be concerned with how "the [bankruptcy] process can maximize the value of a given pool of assets."[22] The economic account suggests that bankruptcy maximizes asset value in several ways. First, it tends to increase the value of separate assets by aggregating them with other assets.[23] Jackson explains that the aggregate value of assets may be increased by keeping groups of assets together, even if those assets are sold in liquidation.[24] Second, it gives creditors who are not the first to file claims the guarantee of payment certain, even though payment may not

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see also Peter Passell, *Critics of Bankruptcy Law See Inefficiency and Waste*, N.Y. TIMES, Apr. 12, 1993, at A1.

17 JACKSON, LOGIC AND LIMITS, *supra* note 4, at 7.

18 *Id.* at 10.

19 Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests*, 51 U. CHI. L. REV. 97, 117 (1987).

20 JACKSON, LOGIC AND LIMITS, *supra* note 4, at 13 (italics in original).

21 *Id.* at 24.

22 *Id.*

23 *Id.* at 14-15. Jackson states that "a collection of assets is sometimes more valuable together than the same assets would be if spread to the winds. It is often referred to as the surplus of a going-concern value over a liquidation value." *Id.* at 14.

24 *Id.* at 14-15.

be on 100% of the claim.[25] Third, it minimizes the costs incurred if each creditor resorted to individual debt collection techniques.[26]

The economic account is based, in part, on a conceptual paradigm known as the "creditors' bargain."[27] The creditors' bargain theory surmises that creditors who unite privately to draft a bankruptcy system *ex ante* would agree to a system that tends to result in increased assets.[28]

The economic account suggests three reasons why unsecured creditors would agree *ex ante* to a collective and compulsory system of debt collection that tends to result in asset maximization.[29] First, such a system reduces uncertainty surrounding the amount each creditor will collect on its claim.[30] Reduction of this uncertainty has two salutary effects: (1) it eliminates "strategic costs" associated with litigation to collect debts; and (2) it reduces "variances in recoveries."[31]

The second reason for unsecured creditors to agree *ex ante* to a collective and compulsory system of debt collection lies in the tendency of a collective proceeding to result in asset maximization.[32] Individualistic remedies dismantle the debtor's capital, leaving each asset worth less than it would be had the assets been pooled.[33]

Finally, the economic account cites administrative efficiencies as a reason for unsecured creditors to agree.[34] Unsecured creditors will agree on a system that requires a "single inquiry into recurring collection questions,"[35] rather than a multiple and often duplicative set of queries.

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25 A wealth of anecdotal and empirical evidence suggests that Jackson's observation regarding certainty of payment is largely theoretical. *See, e.g.*, DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 88, 127, 130 (1971) (reporting that while unsecured creditors usually received nothing in personal bankruptcies, general creditors received an average of 7% on their allowed claims); TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS 199-229 (1989); Vern Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269 (1970) (concluding from extensive personal inquiries of bankruptcy practitioners and judges that general creditors receive little from bankruptcy proceedings).

26 JACKSON, LOGIC AND LIMITS, supra note 4, at 16.

27 Jackson, *Bankruptcy and the Creditors' Bargain*, *supra* note 4, at 858.

28 *Id.* at 860.

29 *Id.* at 860-68.

30 *Id.* at 861-64.

31 *Id.* at 862.

32 *Id.* at 864-65.

33 *Id.* at 864.

34 *Id.* at 866.

35 *Id.*

Why, now, would *secured creditors* agree to such a deal *ex ante*, since their credit agreements with the debtor bestow upon them rights superior to unsecured creditors, including the right to be paid first up to the value of their collateral?[36] The economic account recognizes that secured creditors are not beneficiaries of the advantages of a collective proceeding from which unsecured creditors profit.[37] Nevertheless, the economic account assumes that secured creditors have certain advantages stemming from the minimization of the debtor's total credit costs such that they could be made indifferent to a collective and compulsory proceeding.[38]

The preceding assumptions of the economic account have important implications for bankruptcy rule making. The economic account suggests that bankruptcy law should not create substantive entitlements unless the creation of those entitlements is necessary to maximize net asset distributions.[39] Recognition of new substantive entitlements would be disastrous for two reasons. First, it would "create new incentives for particular holders of rights in assets to resort to bankruptcy in order to gain for themselves the advantages of those changes, even when [bankruptcy] would not be in the collective interest of the [group]."[40] Second, it would reintroduce the problem of "individual self-interest undermining the interest of the group."[41]

According to Jackson and Baird, the economic account explains bankruptcy's distinct purpose and, thus, its inherent limits. Bankruptcy should function as a compulsory and collective proceeding dedicated to asset maximization. It should not change a substantive nonbankruptcy rule unless doing so maximizes assets for distribution to creditors.

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[36] As I have noted elsewhere, hidden complications exist in this statement. *See* Mary J. Newborn, *Undersecured Creditors in Bankruptcy:* Dewsnup, Nobelman *and the Decline of Priority*, 25 ARIZ. ST. L.J. 547, 556 n.26 (1993) (identifying contrasting conceptions of secured credit and applying those conceptions to Supreme Court jurisprudence involving undersecured creditors in bankruptcy).

[37] Jackson, *Bankruptcy and the Creditors' Bargain*, *supra* note 4, at 868-69. It is interesting to note that Jackson explicitly limited his model to fully secured creditors. His stated reason for this limitation was to keep his model simpler. *Id.* at 868 n.54. Jackson admits that in a true creditors' bargain, at least some creditors "face at least *some* possibility of being an unsecured creditor." *Id.* at 870 n.62 (emphasis in original).

[38] Jackson explains that collection costs passed onto the debtor would increase the secured creditors' claims. *Id.* at 869.

[39] JACKSON, LOGIC AND LIMITS, *supra* note 4, at 21.

[40] *Id.*

[41] *Id.*

B. *Criticisms of the Economic Account and the Original Creditors' Bargain*

Professors Elizabeth Warren and David Gray Carlson offer the most penetrating criticisms of the economic account. Warren and Carlson challenge Jackson and Baird's methodology as well as their normative views on the purpose of bankruptcy.

According to Warren, Jackson and Baird stand accused of the sin of using abstract economic analysis as the sole guide to "right" answers.[42] She notes the seductive nature of this method, explaining that it allowed its practitioners to ignore difficult normative questions and useful empirical evidence.[43] Ultimately, however, Warren maintains that Jackson and Baird's narrow perspective greatly hinders their effort to find bankruptcy's distinct purpose.[44] Of course, Warren's claim rests upon her assumption that Jackson and Baird are "wrong" in their view of bankruptcy's underlying purpose.

Warren argues that bankruptcy's distinct purpose stems from its focus on loss allocation among creditors (and others at risk) in the context of multiple defaults.[45] Moreover, loss distribution must account for a variety of factors and values (not just economic ones), including the relative ability to bear the costs of default.[46]

Warren further argues that the economic account itself demonstrates the centrality of loss distribution in bankruptcy.[47] For example, secured creditors have state law repossession rights which are stayed in bankruptcy.[48] Baird endorses this practice in business reorganizations on the ground that it helps preserve the value of an on-going business.[49] Yet, Warren correctly recognizes that this rule

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42 Warren, *Bankruptcy Policy*, *supra* note 8, at 811-14.

43 *Id.* at 812.

44 *Id.* at 813.

45 *Id.* at 777.

46 *Id.* at 790. Warren has recently broadened her original views, although she still prefers to discern what the policy goals of bankruptcy should be from positive observation and empirical investigation rather than abstract theoretical models. "It is important to separate debates about bankruptcy fancy from debates about bankruptcy policy." *Id.*; *see also* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 386 (1993) [hereinafter Warren, *Bankruptcy Policymaking*] (suggesting a list of policy goals for business bankruptcy, including enhancing firm value, distributing firm value, and internalizing costs of business failure).

47 Warren, *Bankruptcy Policy*, *supra* note 8, at 803 n.65.

48 11 U.S.C. § 362 (1988 & Supp. IV 1992).

49 Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 117 (1987).

forces the secured creditor to absorb some of the losses occasioned by the debtor's default.[50]

Professor Carlson has also found the economic account deeply unsatisfying, albeit for different reasons. According to Carlson, one fundamental problem with Jackson's efficiency aims is that they are not in harmony with his contractarian methodology.[51] Carlson observes that the pursuit of economic efficiency requires close analysis of precise historical attributes while the type of contractarian theory that insists on unanimous consent of participants requires extraordinary generality and simplicity.[52] Otherwise, conflicts of interest will arise to prevent unanimity. This means that Jackson (without announcement) simply abandons the contractarian method, which will emphasize the good of the individual over the community whenever he needs to make something appear Kaldor-Hicks efficient.[53] Carlson argues that these manipulations render Jackson's approach "hopelessly ad hoc."[54]

Beyond that analysis, Carlson challenges the notion that the creditors' bargain model even proves its most basic assertions. For example, according to the creditors' bargain model, creditors would agree to a collective and compulsory bankruptcy system instead of state law remedies because bankruptcy enhances the value of the estate. (Remember that, according to the economic account bankruptcy does this by keeping assets together and producing administrative savings by placing all disputes in one forum for resolution.) However, Carlson reminds us that state law may also produce incentives for asset maximization[55] and that bankruptcy has administrative costs of its own that may equal or exceed state law collection costs.[56]

Carlson expresses confident skepticism over the ability of any scholar to find a singular and totalizing theoretical structure in bankruptcy.[57] He views bankruptcy law as the product of, among

[50] Warren, *Bankruptcy Policy*, *supra* note 8, at 803.

[51] Carlson, *Philosophy*, *supra* note 9, at 1342-45.

[52] *Id.* at 1343.

[53] *Id.* at 1344.

[54] *Id.* at 1341.

[55] *Id.* at 1355. Carlson points out:

> It is possible to imagine [state law] systems in which the sheriff has the motive to maximize the sales price, as where her poundage fee is directly related to the sales price. After all, how is the bankruptcy trustee's motive any different? Her fee too is based upon maximizing the sales price.

Id. at 1354-55 (citations omitted).

[56] *Id.* at 1355.

[57] *Id.* at 1389.

other things, contradictory ethical considerations, political compromises, and rational judgments.[58]

C. *Professor Korobkin's Response*

Professor Korobkin finds flaws in both the economic account and the responses of its critics. While Korobkin argues that the economic account too narrowly defines the problem to which bankruptcy is designed to respond (namely, debt collection), he does not believe that its critics have provided a satisfying theoretical alternative.[59]

Korobkin suggests that the real problem to which bankruptcy responds is the problem of "financial distress," in which an individual or corporation faces "demands" from many different persons.[60] These demands can be moral, social, personal, political, and financial.[61] Korobkin describes a situation of conflict and chaos as each person presses these demands.[62] As demands are made and met, the capacity of the individual or corporation to satisfy future demands is impaired.[63] Korobkin argues that bankruptcy exists to respond to this broader problem, rather than the more narrow problem of debt collection or even loss allocation,[64] and responds to the problem of financial distress by "[providing] a forum in which competing and various interests and values accompanying financial distress may be expressed and sometimes recognized."[65] Korobkin asserts that bankruptcy ultimately can be explained as a system for "rendering richer, more informed decisions in response to financial distress."[66] To this end, Korobkin suggests that bankruptcy law should alter substantive nonbankruptcy rights if doing so would result in improved conditions for bankruptcy discourse in the context of financial distress.[67]

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[58] *Id.* Carlson writes:

> The whole idea of finding a deep structure in a complicated, historic artifact such as the Bankruptcy Code was doomed from the start. Considering the tens of thousands of congressmen, judges and lawyers who have contributed to the content of bankruptcy law, it would have been a miracle if all of them were driven by the same ethical impulse every time a legislative decision was made.

Id.

[59] Korobkin, *Rehabilitating Values*, *supra* note 10, at 718-21.

[60] *Id.* at 764.

[61] *Id.* at 765.

[62] *Id.* at 764.

[63] *Id.*

[64] *Id.* at 766.

[65] *Id.*

[66] *Id.* at 787.

[67] *Id.* at 789.

Once Korobkin identified the problem he thought bankruptcy exists to cure, he searched for normative principles that might guide the reconciliation of competing aims and values in financial distress. He based his normative theory on the hypothetical choice situation described by John Rawls in *A Theory of Justice*.[68] In that work, Rawls suggested that the proper moral principles to govern society are those that people would choose behind a veil of ignorance concerning their own particular interests and conceptions of the Good.[69] Rawls argued that behind that veil, one would choose to secure equal liberties and permit only those social and economic inequalities that would operate to benefit the least well-off by providing those better-off with necessary incentives.[70]

In Korobkin's bankruptcy choice model,[71] individuals are charged with choosing principles to govern relationships in financial distress.[72] The assembly of individuals includes representatives of all persons in society who potentially are affected by financial distress.[73] These representatives know their task and the circumstances of financial distress.[74] However, these representatives do not know their legal, political, and personal characteristics.[75]

Korobkin asserts that these representatives would choose two principles to govern relationships in financial distress: (1) "the principle of inclusion";[76] and (2) "the principle of rational planning."[77] Before critiquing these principles, we will compare them with the type of principles that might emanate from the original creditors' bargain. This comparative analysis suggests answers to two questions identified at the outset of this Article. First, why do the principles of inclusion and rational planning differ from the principles that the parties in the original creditors' bargain might select? Second, what, if anything, do these principles contribute to our understanding of bankruptcy law? We begin with the principle of inclusion.

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68 Korobkin, *Contractarianism*, *supra* note 11, at 544 ("the bankruptcy choice model closely follows the paradigm of the hypothetical choice situation as originally developed by John Rawls in A Theory of Justice").

69 JACKSON, LOGIC AND LIMITS, *supra* note 4, at 12.

70 *Id.* at 14-15.

71 Korobkin, *Contractarianism*, *supra* note 11, at 544.

72 *Id.* at 545.

73 *Id.* at 571.

74 *Id.*

75 *Id.*

76 *Id.* at 545.

77 *Id.*

III. The Principles of Bankruptcy Under the Bankruptcy Choice Model

A. *The Principle of Inclusion*

According to the principle of inclusion, "each person affected by financial distress [should] have a threshold eligibility to press his or her demands in that context."[78] The principle of inclusion would not deny anyone the opportunity to promote his or her aims in financial distress simply because of his or her status.[79] Korobkin speculates that the parties to the original creditors' bargain would choose a different principle—the "principle of creditor eligibility."[80] Under this principle, only those persons with consensual legal claims against the debtor's assets (i.e., contract creditors) can gain recognition from a financially distressed firm.[81]

Firstly, the notion that the persons in the original creditors' bargain would choose a rule of creditor eligibility over a rule of inclusion seems persuasive, given the bargain's contrived assumptions concerning representation and knowledge. As regards representation, contract creditors constitute the only persons described in the original creditors' bargain.[82] No one else exists for purposes of selecting the principles. However, even if other persons are simply present while the contract creditors agree to the principles, no mechanism exists through which the interests of these "other persons" can be recognized.

Regarding knowledge, these creditors know that they are contract creditors with either secured or unsecured claims.[83] They do not even fathom the possibility that anyone else exists with whom they might have to share recognition. Even if they appreciate that possibility, they are not altruistic. Instead, they are engaged in the selfish pursuit of their known interests.[84] Given these conditions, it seems highly unlikely that these contract creditors would select a principle that allows those without formal legal claims to be heard. Indeed, to the extent that it limits the number of financial and other demands placed on the estate, a rule of creditor eligibility restrains transaction costs, thereby furthering the creditors' selfish desire for asset maximization. A gathering of contract creditors—

[78] *Id.* at 575.
[79] *Id.*
[80] *Id.* at 572.
[81] *Id.*
[82] Jackson, *Bankruptcy and the Creditors' Bargain*, *supra* note 4, at 860-71.
[83] *Id.* at 869 n.59.
[84] *Id.* at 868; *see also* Carlson, *Bankruptcy Theory*, *supra* note 6, at 463.

under these circumstances—would probably produce a principle of bankruptcy that restricts recognition to contract creditors.

Competing conceptions of representation and knowledge influence the selection of the principle of inclusion. Firstly, the bankruptcy choice theory does not restrict representation to contract creditors. All those potentially affected by financial distress ("employees, managers, directors, members of the community and so on"[85]) are represented in the assembly that selects the principles.[86] A more diverse assembly might result in a more inclusive rule because the participants themselves manifest, without knowing it, a plurality of interests.

As regards knowledge, persons in the bankruptcy choice situation have no idea what positions they will inherit in financial distress.[87] They only know that persons in financial distress pursue diverse aims.[88] Being rational and mutually disinterested in each other's welfare,[89] persons in the bankruptcy choice situation seek to maximize their ability to promote their aims, regardless of what those aims turn out to be. Ignorant of their respective positions, yet conscious that they could become any one of a number of persons affected by financial distress, Korobkin's claim that they might prefer the principle of inclusion seems reasonable.

The principle of inclusion succeeds as a descriptive device by simply underscoring the standard observation that the reach of bankruptcy law extends beyond the confines of debtor-creditor relationships.[90] Understood in these terms, the principle may enhance our understanding of bankruptcy law. Consider, for example, the rejection of executory contracts in bankruptcy.[91] According to the classic definition, an "executory contract" is a contract that requires substantial performance on both sides.[92] Bankruptcy law preserves the trustee or debtor-in-possession's

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[85] Korobkin, *Contractarianism*, *supra* note 11, at 574.

[86] *Id.* at 571.

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.* at 590-91 ("The basic structure of the Bankruptcy Code defines its province in broader social terms.").

[91] 11 U.S.C. § 365 (1988 & Supp. IV 1992).

[92] *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). This definition has come under attack in recent years. *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845 (1988); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991) (arguing that all future contractual obligations either must be performed or breached by the debtor and that the "executoriness" of a contract should be irrelevant to that decision).

right to reject an executory contract. A brief hypothetical demonstrates how this might work: Assume that Johnny Apple Co. ("JAC") supplies apples to local grocery stores. JAC has filed for Chapter 11 bankruptcy, at which time, JAC has a contract with Washington Apple Co. ("WAC"), an apple grower. JAC has promised to buy 200,000 bushels of apples from WAC for 75 cents a bushel. Two weeks after the petition was filed, the price of a bushel of apples has fallen to 65 cents a bushel. Section 365 of the Code allows JAC, as the debtor-in-possession, to reject its contract with WAC and buy apples at the lower price on the open market.[93]

Jackson might trace this rejection power to the principle of creditor eligibility and we can imagine Jackson's argument taking the following form: If JAC rejects the contract, it saves the debtor-in-possession $20,000 ($150,000-$130,000), at least some portion of which might be available for creditors in the reorganization plan.[94] Rejecting the contract may leave the contract creditors as a group in a better position than if the contract were to have been performed. Rejection, then, can be understood as an expression of the principle of creditor eligibility.

However, Korobkin might connect the rejection power to the principle that recognizes a broader constituency. Although Korobkin has not developed this connection fully, he might be read as suggesting that rejection (particularly in the reorganization context) necessarily implicates the varying concerns of a wide range of persons, not just contract creditors.[95] Rejecting the unprofitable contract between JAC and WAC may preserve JAC's viability as an on going business, not just for contract creditors, but also for employees and managers who have moral, political, social, and economic interests in maintaining their jobs. The principle of inclusion thereby recasts a seemingly narrow legal decision into one more comprehensive in its scope and effects.

Unfortunately, the principle of inclusion also suffers from a frustrating vagueness. In describing the principle's domain, Korobkin writes:

> The principle of inclusion, it should be emphasized, does not speak at all to which particular demands should ultimately be recognized and which should be denied. It provides only that no

[93] The decision to reject is subject to court approval under a "business judgment rule." *See* Lubrizol Enters. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1046-47 (4th Cir. 1985). In our hypothetical, we assume that JAC has sufficient cash on hand to purchase the apples at the lower price.

[94] JACKSON, LOGIC AND LIMITS, *supra* note 4, at 108.

[95] Korobkin, *Contractarianism*, *supra* note 11, at 590.

> persons should be disqualified from pursuing their aims merely by virtue of the position they occupy.[96]

So formulated, the principle of inclusion might not be helpful in solving difficult interpretative questions or policy dilemmas in bankruptcy law.[97] It offers only a general claim that everyone affected by financial distress should have the *potential* to promote their aims. This claim prompts several practical questions. For example, how does a decisionmaker grant someone a *possibility* of being heard?[98] How does this principle mediate conflicts between inclusion and other values, such as efficiency? How do we distinguish between those who are affected by financial distress and those who are not so affected? The principle of inclusion offers no means of adjudicating contending claims and this omission is likely to limit its prescriptive power.

B. *The Principle of Rational Planning*

Korobkin's second principle—the principle of rational planning—has two central components. First, it seeks to maximize (i.e., promote most fully and effectively) diverse aims by using a rational long-term plan for the business enterprise.[99] Second, the principle

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96 *Id.* at 575.

97 For example, if, as Korobkin suggests, the trustee's avoidance powers are an expression of the principle of inclusion, then what is the proper scope of those powers? *See* Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186 (7th Cir. 1989) (holding that transfers potentially benefiting insider guarantors are avoidable under § 574(b) against non-insider transferees). If, as Korobkin suggests, the bankruptcy discharge is an expression of the principle of inclusion, then what is the proper scope of the discharge policy? *See In re* Jensen, 995 F.2d 925 (9th Cir. 1993) (holding that the State of California had sufficient knowledge of a debtor's potential liability to give rise to pre-petition, contingent, and dischargeable "claim" for hazardous waste clean-up costs).

98 Korobkin specifically rejects attempts to link the principle to the resolution of the specific legal issue of "standing" in bankruptcy:

> Properly understood . . . the principle of inclusion does not speak to the question of who should have legal standing in bankruptcy court. The [ ] principle has a more general point, establishing the threshold proposition that no person should be categorically denied the possibility of pressing his or her demands in the larger context of financial distress. In contrast, the legal question of formal standing involves the logically subsequent issue of whether persons—already determined to be eligible to assert their demands in financial distress—should have their individual aims promoted or frustrated.
>
> It is the province of the second principle of bankruptcy—the principle of rational planning—to determine whether the aims of eligible persons should be promoted by the grant of legal standing, or in any other way.

Korobkin, *Contractarianism*, *supra* note 11, at 575 n.162.

99 *Id.* at 581. It should be noted that Korobkin does not restrict the principle of rational planning to business only. The principle can be applied to bankruptcies involving individuals as well.