

A New Bargaining Theory of Corporate Bankruptcy

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Existing Framework

Creditors' Bargain Theory

Bankruptcy purpose is to mimic the hypothetical agreement that parties would have entered into

Butner Principle

Bankruptcy should respect non-bankruptcy entitlements

Where it Works

Collective action problem and race to the assets

General creditors need to coordinate behavior, but have no existing relationship with each other

If they had a relationship, they would have chosen efficient rules (like the automatic stay)

There are likely large inefficiencies if bankruptcy changes their substantive rights (like forum shopping)

Limitations

Bankruptcy presents many problems beyond “collective action”

(Baird and Picker 1991; Baird, et al 2007; Ayotte and Skeel 2013; Adler 2018; Skeel and Triantis 2018)

Hypothetical bargain is not a good fit for problems in actual agreement between sophisticated parties.

Parties did bargain and transactions cost for convening a bargain are low

Doesn't match what is going on in the world

Reframing things

Problem: Opportunistic hold-up behavior associated with incomplete contracting over financial distress.

Scope: This implies that it should only deal with parties who have disputes involving relationship specific investments

Solution: Structured renegotiation to reduced opportunities for hold up

Note: Non-bankruptcy entitlements only matter if respecting or altering them can help bankruptcy law align (or distort) opportunities and incentives for efficient behavior

The Chapter 11 Solution

Set up a structured space for renegotiation

Judge oversees the positions parties take

The law sets substantive parameters or outer bounds within which parties' negotiation

These parameters are set based on estimations of the likelihood of hold up

The Chapter 11 Solution

Exceptions can be invoked but judge's discretion is limited

To alter a default rule a party often must

- Pay an estimated price

- Market test their position

- Convince judge subject to a very high burden

Note: You have to trust judges for this to work

Applications: Cram Down

Default: Secured Creditor exercises foreclosure right

Altering Rule: Can suspend that right if

- (1) sale that thoroughly market tests the value given
- (2) Creditor gets new terms that match the terms of?

Correct view: Debtor must pay no less than it would pay on the market for a new loan

Or

- (3) Creditor gets “indubitable equivalent”

Other Applications

Enforcement of intercreditor agreements

Assumption of executory contracts

Third-party releases