Dealing with Failure: Why Corporate Bankruptcy is not like Death

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Abstract: Bankruptcy law is an institution that both defines failure and then treats it; it is the basic legal vehicle through which market economies impose hard budget constraints and weed out unprofitable or inefficient firms. As the current crisis deepens, the terms and procedures of bankruptcy law will unfortunately become increasingly relevant for insolvent firms and overly indebted individuals. Depending on the depth and length of this crisis, the failure of the economy to perform may eventually undermine political support for the institutional foundations that underpin a market economy (the Polanyi problem). This paper focuses primarily on corporate bankruptcy law, and uses the experience of the Asian Financial Crisis to draw some lessons for how crises reshape bankruptcy law, and what consequences (both expected and unexpected) follow.

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"Capitalism without bankruptcy is like Christianity without hell." Frank Borman, Apollo 8 astronaut and Eastern Airlines CEO, 1981

"Bankruptcy is perhaps the greatest and most humiliating calamity which can befal an innocent man. The greater part of men, therefore, are sufficiently careful to avoid it. Some, indeed, do not avoid it; as some do not avoid the gallows." Adam Smith, Wealth of Nations Book II, p.363

America is the land of second chances. Tocqueville noted that without a hereditary aristocracy, America gave opportunities to people who in Europe would have been doomed to a one-track life. Today, U.S. educational institutions are sufficiently open that someone who doesn't do well in high school can still recover with a strong performance in college, and a person who is a stellar undergraduate at a mediocre university can still get into a top graduate or professional program, and get back on track. Historically, second chances have also come in the marketplace. People whose businesses have failed or whose personal finances have been crushed by debt can file for bankruptcy, liquidate their assets, discharge their debts, and get a fresh start. A bankrupt person was a failure, to be sure, but an "honest" bankrupt could try again and still succeed. Since the 19th-century, American bankruptcy laws have been relatively "debtor friendly" (Balleisen 2001). It may have been easier to sympathize with American debtors in an era when creditors so often came from elsewhere (out of state, or from abroad). At the very least, domestic debtors could vote (and so wield direct political influence) whereas external creditors could not. Nevertheless, the balance between debtors and creditors shifted as bankruptcy laws were passed, repealed, or reformed. Furthermore, bankruptcy laws have accommodated a changing balance between business and individual bankruptcies as the latter became numerically dominant. And within corporate bankruptcy, the traditional emphasis on liquidation has shifted as people have come to

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appreciate rehabilitative possibilities for firms. Modern bankruptcy law allows for corporate reorganization (organizational "rebirth") as well as liquidation (organizational "death"). All of these changes have produced a law that is distinctive by international standards, and so, for example, even today British insolvency specialists marvel at the "insanity" of debtor-in-possession provisions within Chapter 11 corporate reorganizations.

In this paper, I will emphasize corporate bankruptcy law. The most recent set of legal reforms in the U.S. (2005) focused on provisions for individual bankruptcy (Warren and Westbrook 2009: 106), and understandably those provisions possessed a good deal of political salience (especially in regard to the disposition of credit card debts). The recent economic crisis has, however, put the spotlight back onto corporate bankruptcy as a considerable number of large firms flirt with insolvency or fail outright. As a mechanism for economic restructuring in an economy dominated by private for-profit firms, corporate bankruptcy law necessarily plays a key role.

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Bankruptcy and Capitalist Democracy

In capitalist economies, corporate bankruptcy law is the primary legal institution whose purpose is to deal with economic failure.[1] Bankruptcy is a redistributive institution, activated only when a firm becomes insolvent or otherwise cannot pay its bills

[1] My approach is broader than that embraced by some notable bankruptcy scholars. Jackson (1986), for example, views bankruptcy law primarily as a debt-collection device that specifically addresses the collective action problems faced by creditors. Individually, the creditors of an insolvent firm have an incentive to rush to the assets, but the overall value of the insolvent firm is frequently greater if it isn't pulled apart piecemeal. So bankruptcy puts a stop to creditors' individual collection efforts (via the "stay").

as they become due. Neither criterion is unproblematic because solvent but illiquid firms may have difficulty, for a time, paying their bills, and balance sheet tests (i.e., liabilities greater than assets) are subject to the vagaries of accounting rules and creative asset valuation methods.[2] Leverage (i.e., contractually-obligatory indebtedness) sets the conditions for bankruptcy. Borrowing in some fashion is usually necessary to run a modern business, but too much leverage makes a firm vulnerable. The particular "triggers" that can activate bankruptcy proceedings, and whose finger sits on the trigger, vary from one law to the next. There may be more-or-less discretion involved, and the debtor firm itself may file voluntarily for bankruptcy or be pushed involuntarily into bankruptcy by someone else.

Whether in a liquidation or reorganization proceeding, bankruptcy spreads the losses around among those who have a claim on the firm. With limited liability, the burden of loss is shifted from shareholders and owners to creditors.[3] This puts many of the claimants in direct conflict with each other: more for one means less for the others. Thus, bankruptcy law functions to resolve complicated and conflicting interests. And it does so in mandatory fashion, backed by the coercive power of law. Of course, many troubled firms try to reorganize before formal bankruptcy proceedings begin: informal workouts and debt renegotiations can also restructure a firm's contractual obligations. But these interventions function in the shadow of the law, even if they do not occur inside a bankruptcy court.[4]

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[2] Valuation of assets continues to be problematic once inside the bankruptcy court as different parties will often contest the "true worth" of assets. Consider the implications of valuation for control over a chapter 11 proceeding (see Warren and Westbrook 2009: 699).
[3] Similarly, for personal bankruptcy the discharge means that the burden of a debtor's losses over and above the value of the debtor's non-exempt assets is shifted to the creditors.
[4] Consider, for example, the extent to which GM's current negotiations with its bondholders and the UAW are shaped by what could happen in a bankruptcy court.

The encompassing and binding nature of a bankruptcy proceeding recognizes the interdependencies among the creditors and stakeholders of a particular firm. Without expecting to, parties to bilateral agreements find themselves in a multilateral situation. Anticipation of insolvency may set off a very destructive "rush to the assets" among creditors, and state collection laws in fact encourage creditors to try to seize assets as quickly as possible (Warren and Westbrook 2009: 46). The "stay" imposed by a bankruptcy court is intended to prevent such an outcome by halting all collection efforts. Although their interests conflict, creditors can all benefit if bankruptcy proceeds in an orderly fashion.

Contract law and property rights are two other key institutional features for capitalist economies. Contracts allow people to make legally-binding agreements and property rights allow individuals (whether real or fictive) to assert legally-enforceable claims over assets. In effect, these institutions offer well-defined rules that specify who owns what, and how ownership rights can be exchanged in the market. The ostensible inviolability of these rules is signaled by concepts like the "sanctity" of contract and property. But in fact these rules are not inviolable and with some regularity bankruptcy law will, under certain conditions, attenuate or even negate contractual and property claims. Those special conditions involve some kind of economic distress. Bankruptcy adds necessary flexibility to existing claims and relationships that are no longer viable.[5] And the specific features of bankruptcy law dictate who has to bend in the face of unpleasant economic realities, and by how much.

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[5] As Macaulay (1963) noted, firms also use incomplete contracts, or even non-contracts, to maintain flexible transactions in non-distressed circumstances.

Bankruptcy law offers a legal vehicle through which market economies impose hard budget constraints. It is part of the selection mechanism that "weeds out" less efficient firms, and so drives the neo-Darwinian process that is ostensibly one of the virtues of competitive markets: unprofitable firms eventually disappear, and their human and physical assets are taken over by others. But bankruptcy as a process has its own costs, and these are not trivial (Stiglitz 1994: 100). Consequently, many countries do not give bankruptcy law free rein (Warren and Westbrook 2009: 882). Some types of firms are too important, or produce outputs that are too central, to be subject to ordinary bankruptcy rules (typical examples include banks, utilities, and insurance companies). Firms can be "too big" or "too important" to fail.

Matters are further complicated by the fact that the basic institutions of the market rest, in capitalist democracies, on the polity. The three I have mentioned thus far, contract law, property rights, and bankruptcy law, are all specified and enforced by the apparatus of government. And the latter is subject to democratic control. Capitalist democracies necessarily involve democratic political influence over the economy. This means that economic outcomes and circumstances can have political consequences that feed back into the basic institutions that uphold the market. For example, onerous or predatory contracting may produce a political backlash that prohibits such contracts. Extremely unequal distributions of private property can spark political efforts to redistribute wealth. In general, market economies produce risks that are often managed outside of the market, through some kind of public policy or government intervention (Moss 2002).

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Bankruptcy law also carries political baggage in that economic failure is a decidedly unpopular outcome, and when it becomes too widespread, when bankruptcy

results in high levels of unemployment, there is a potential for politically-inspired legal reforms to protect insolvent debtors and vulnerable workers. Legal institutions producing failure that permanently immiserates people will simply not survive the first serious economic downturn; in such a situation, people would change the rules of the game to redefine failure in a less destructive fashion (Rajan and Zingales 2003: 278,300).[6]

Failure, dissolution, liquidation, and unemployment are all part of the unpleasant underside of capitalism. One of the political tasks of bankruptcy law is to help manage and legitimize the failure that is necessarily part of a market economy, but without diminishing the political support for capitalism itself. Bankruptcy law has, in other words, a Karl Polanyi-esque mission. It is part of the institutional framework that upholds a market society, and protects capitalism from itself. Failure has to proceed, and its costs distributed, in a way that seems fair and legitimate even if no-one likes the outcome (think how easy win-win situations are to manage – bankruptcy is a lose-lose situation). The problem is especially acute when bankruptcy is systemic. Consider that high rates of unemployment brought about by widespread failure in the transitional economies of Eastern and Central Europe during the early and mid 1990s had the incredible political effect of rejuvenating the communist party in some areas. If most voters are suffering because the economy is doing poorly, or because capitalism is failing to deliver the goods, then there will be political repercussions.

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[6] If this seems implausible, consider the political pressure currently brought to bear on the Financial Accounting Standards Board to alter mark-to-market accounting rules so that banks do not have register the full magnitude of their losses on investments like subprime mortgages. See the New York Times, March 31, 2009, B1. Once this rule change occurred, bank share prices soared. See the Financial Times, April 2, 2009. There are interesting parallels to be explored between early-modern notions of “fair price” and the 21st-century idea that an “abnormally” illiquid market does not generate “fair” prices for bank assets.

Over the last several decades, with the renewed neo-liberal emphasis on market governance of economic relationships, with the transition of command economies to market economies, and with widespread privatization and deregulation, bankruptcy has become increasingly significant. Up until the current economic crisis, it seemed that the days of soft budget constraints and political intervention in the marketplace were over. The Great Moderation of the last several decades seemed to reflect greater mastery by public authorities over macro-economic management, so that business cycles were less volatile (at least in the U.S. and Western Europe). It meant that troughs in the business cycle were less severe and not so many firms were stressed. But with the current crisis, unsurprisingly, there has been a wave of dramatic interventions as national governments struggle to prevent complete collapse of their financial systems. Sadly, bankruptcy is a hot topic again.

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Bankruptcy as a Process

Unwilling flexibility is the flip-side of economic failure. Whether in a liquidation or a reorganization, legal claims over a firm will be adjusted “downward” to absorb the losses sustained by the debtor, or to reduce the firm’s costs so that it can return to profitable operation. And the bundle of claims and interests in a particular firm are variably flexible. Some can be adjusted more easily than others, and their vulnerability to revision is partly a function of rules of priority, and partly a function of the bargaining that occurs before a bankruptcy filing, and afterwards in the negotiation of a reorganization plan. For example, secured claims are harder to adjust than unsecured

claims since collateral is not an issue for the latter. Collective bargaining agreements with unionized workforces are less malleable than individual employment contracts. Bankruptcy laws set out a bundle of rules that impose *ex post* flexibility in situations of financial distress. Of course, creditors' claims over a troubled debtor can be loosened outside of bankruptcy, as when a firm renegotiates a bank loan to stretch out payments, reduce the interest rate, or swap debt for equity. But bankruptcy law provides mechanisms that bind all creditors, and allow renegotiated arrangements to be put in place even over the objections of a minority of creditors (via "cramdown"). It is not, of course, free. The costs associated with a business bankruptcy depend on the complexity of the case and whether issues are contested or not. Reorganizing a large corporation invariably requires the efforts of many expensive attorneys, accountants, and work-out specialists, and their fees diminish the assets available for other claimants on the firm. According to LoPucki and Doherty's study of large, public company reorganizations (2004: 127), professional fees and expenses on average consume about 1.4% of the firm's total assets. They also found that the relative size of fees and expenses was higher for smaller firms, and that lengthier bankruptcy cases entailed higher fees and expenses.

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One key issue is initiation. Who can activate the rules of bankruptcy and when? Obviously, corporate managers know more about the real financial situation of their firm than do creditors and other stakeholders and thus can best judge if their firm is truly in difficulty. But as the firm sinks deeper into insolvency, it is creditors' money that is at stake and managers have little incentive to invoke a proceeding that could well terminate their own jobs and tarnish their reputations. Creditors can also instigate proceedings, but in some situations they too may be reluctant to press their claims. Pushing a debtor into

bankruptcy forces a creditor to recognize their own losses, and this may set off unwanted consequences. For example, if a bank has to reclassify a loan from "performing" to "non-performing" status, it must set aside capital to cover its losses. Banks may simply prefer to roll a loan over, folding missed payments into the new loan, pretending that everything is fine and hoping that the debtor firm can dig itself out of trouble and eventually repay its debts. Both parties can be subject to the "over-optimism" biases identified by behavioral economists, where people over-estimate the likelihood of success (in this case, the likelihood that the troubled firm will perform well again), or they are overly-confident about their ability to turn the firm around,[7] or they are averse to recognizing the losses that have occurred or are likely to occur in the future (Odean 2004, Camerer 2004: 155, Langevoort 2000: 149-150).

Institutionalist political scientists have distinguished between rule-makers and rule-takers (Streeck and Thelen 2005: 13-14). One obvious interpretation of this distinction is to suppose that the rule-makers consist of politicians (legislators, prime ministers, presidents and governors) who pass laws, and the rule-takers are the people and entities who are subject to those laws. Regulation involves a prediction that rule-makers make about the impact of the rules they devise on rule-takers, and obviously this prediction can be more or less accurate. Furthermore, the ruler-takers who lobby politicians are also making predictions about how a proposed set of rules will affect their own interests. Like everyone else, they too can be surprised by how a rule works in practice.

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In fact, such predictions are usually inaccurate and the only question is by how much. Small inaccuracies won't generate much concern, but gross inaccuracy can be a

[7] Indeed, corporate CEOs are recruited, in part, because of their charismatic self-efficacy (Khurana 2002).

problem that engenders further rule-making. Furthermore, the compliance of rule-takers can be with the letter of the rule or the spirit of the rule. Since these often diverge, rule-makers can be surprised as much by compliance as by non-compliance among rule-takers (similar surprises arise in the context of legal transplants, as discussed by Pistor et al. 2002 and Berkowitz et al. 2003). Unpredictability may also depend on the nature of the rules, and whether they are primarily constraining or enabling. Constraining rules set limits on what actors can do, and prohibit various courses of action. In effect, they attempt to reduce the variance of action (think of rules like the Ten Commandments). Enabling rules open up possibilities and create platforms for new kinds of action (think of the rules of a new computer programming language). In addition, unpredictability arises from the sheer heterogeneity of the population of rule-takers. Businesses who file for Chapter 7 or Chapter 11 bankruptcy range in size from mom-and-pop grocery stores to global corporate giants producing household name products. A provision designed with small businesses in mind can have unintended consequences when applied to big business, and vice versa.

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In some instances, the result of having a particular corporation go through an ordinary bankruptcy proceeding is so undesirable that normal bankruptcy rules are suspended and the troubled firm is addressed politically on an ad hoc basis (this would obviously include firms that were "too big to fail"). When the overall economic situation is very bad, and there is systemic insolvency, then ordinary bankruptcy rules will likely be suspended since they cannot deal with mass bankruptcy, nor with too many "too big to fail" firms. Thus, for political reasons, bankruptcy is not an unavoidable fate for troubled firms.

Another surprise comes from the basic ruler-maker/taker distinction itself. Who really makes rules? Those who write legislation or formal regulations may seem the obvious rule-makers, but in fact rules are also "made" by those who implement or enact them. While formal rule-making often occurs in centralized locations (Congress, the White House) and with a considerable amount of attention, implementation happens in a more decentralized and low-profile fashion. In fact, no set of formal rules is entirely consistent, complete and unambiguous (Streeck and Thelen 2005: 14). Gaps always have to be filled, inconsistencies resolved, and rules interpreted. Implementation unfolds, usually in mundane fashion, after political attention has moved on to the next big problem. And here the interests of the implementers play a role. They may wish to implement selectively, slowly, or not at all (in the latter case, rules and action are completely decoupled). Given the significance of implementation, it is more accurate to speak of three groups: rule-makers, rule-implementers, and rule-takers.

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In the case of bankruptcy law, legislators are the initial rule-makers. They pass or reform bankruptcy laws that subsequently govern the behavior of rule-takers (individuals and businesses operating in a credit economy, either as debtors or creditors, or both). It is easy to see that rule-takers have a stake in the substantive and procedural details of the rules since these will have a direct impact on their interests. For example, secured creditors will want to ensure that bankruptcy rules do not undermine the priority of their claims over collateral. Individual debtors will want to have as complete and unconditional a discharge as possible. Corporate debtors trying to reorganize their firm value a judicial "stay" that stops all debt-collection proceedings by creditors and will want to maintain control over a firm's assets for as long as possible. And so on. Because

bankruptcy rules can so deeply affect their interests, rule-takers try to organize politically and pressure rule-makers to produce laws that favor their interests. In this respect, the reform of bankruptcy looks like a standard venue for interest group politics. Rule-takers who are more easily organized (usually creditor groups like banks or credit card companies) lobby politicians for rules that favor themselves.

The significance of implementation complicates these political processes. Like rule-takers, rule-implementers also have interests, and those interests affect implementation and rule-making. Rule-implementation is a kind of work, and raises the issue of who controls that work and what kind of benefits they derive from its performance (these can be considered "jurisdictional interests," akin to those of professional groups that monopolize particular kinds of expert work). The outcome of bankruptcy affects various economic interests among debtors and creditors as rule-takers, but the process of bankruptcy affects the jurisdictional interests of rule-implementers. In the U.S. this means that lawyers and judges shape both rule-implementation and, because of their jurisdictional interests, rule-making. Carruthers and Halliday (1998) show how the jurisdictional interests of these two groups shaped the 1978 reform of U.S. bankruptcy law as lawyers and judges combined to ensure that bankruptcy remained a legal, rather than an administrative process (which various reform groups were pushing for). Furthermore, as reformers tried to raise the stature of bankruptcy judges in order to attract better legal talent, they ran into the jurisdictional interests of federal judges, who were reluctant to share their august position with jurists they regarded as their status-inferiors.[8]

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[8] Obviously, not all the experts involved in legal reform narrowly pursue their professional interests.

Not all stakeholders in bankruptcy are recognized as rule-takers. That is, there are groups affected by bankruptcy proceedings who are not officially covered by the purview of bankruptcy rules. The set of legal claimants on an insolvent firm is only a subset of all the stakeholders with an interest in a firm. Non-claimant stakeholders include, for example, the businesses and employees who would be adversely affected by the liquidation of a local firm even though they are not direct creditors of that firm. They also include, as another example, future victims who may suffer adverse long-term health effects from the industrial pollution currently produced by a firm. Should that firm become insolvent, and fail to clean up the environmental damage it has caused, people who are not claimants of the firm will nevertheless feel the effect of its insolvency. Although such stakeholders have no official standing in a bankruptcy court, when mobilized they can exert political influence to try to ameliorate the effects of bankruptcy. In sum, the nexus of interests for a given corporation is wider than the nexus of contracts, and for non-claimant stakeholders, bankruptcy has externalities (Stiglitz 2001: 4).

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There are important differences even among those stakeholders who have the legal claims that make them official creditors. In their critique of recent "contractualist" scholarship, Warren and Westbrook (2005) document the prevalence of "maladjusting creditors," creditors who if excluded from bankruptcy bargaining would find it hard to adjust adequately their financial contracts outside of bankruptcy (e.g., involuntary creditors. Because creditors cannot always fully compensate outside of bankruptcy for what happens inside bankruptcy, the latter matters. Depending on who is actively involved in bankruptcy bargaining, the outcomes can be skewed in ways that are significantly redistributional.

The likelihood (perhaps certainty is more accurate) of unintended consequences is one reason why rule-makers should anticipate the need to update their rules in light of how they are applied. Rules should not be considered "finished" when written. Rather, rules should be understood as a first provisional move in a co-evolutionary process that unfolds among rule-makers, rule implementers, and rule-takers. Of course, constructing rules that accommodate "mid course corrections" sounds good in principle but can be hard to achieve as a practical matter. To appreciate the impact of unintended consequences, it is useful to have a brief look at implementation in two contexts.

Bankruptcy Implementation

For some years after the Asian financial crisis, the IMF, the World Bank, the Asian Development Bank, and the UN Commission on International Trade Law (UNCITRAL) expended considerable effort trying to develop a "global standard" or "global norm" for bankruptcy law (Halliday and Carruthers forthcoming).[9] In part, these efforts followed IMF bailouts of countries like South Korea, Indonesia and Thailand, in which commercial legal systems, and bankruptcy laws in particular, came under considerable criticism from foreign experts. The general diagnosis was that East Asian economies lacked the predictability and transparency that came with proper "rule of law" (Carruthers and Halliday 2007). So as a condition of their bailout loans, these countries were told to reform their bankruptcy laws and bring them up to world standards. It was only after much expert negotiation and deliberation, unfolding over years, that

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[9] Consider the IMF's 1999 Orderly and Effective Insolvency Procedures, and the World Bank's 2001 document.

UNCITRAL produced its Legislative Guide on Insolvency Law in 2004. In the meanwhile, the IMF and World Bank pressed for more ad hoc legal reforms (spelled out in various "letters of intent") that would, from their perspective, improve bankruptcy law in East Asia and help put an end to "crony capitalism."

Recipient countries had to comply with loan conditionalities, but before too long the realities of implementation became apparent. In the case of Indonesia, for example, a new bankruptcy law was passed at the behest of the IMF and written with the assistance of able foreign legal experts. But when these new rules were implemented through the Indonesian courts, things got very interesting. Seemingly iron-clad claims of foreign creditors over Indonesian assets didn't survive Indonesian judges whose creative interpretations of the new law astounded outside observers (Halliday and Carruthers forthcoming, chapter 5). Rule-implementers effectively rewrote the rules in ways that favored domestic debtors over foreign creditors.[10]

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Rule-implementation occurs in the U.S. as well as abroad. Lynn LoPucki (2005) shows how in recent decades competing bankruptcy courts in the U.S. variably interpreted the same bankruptcy code in ways that favored incumbent corporate management, in order to attract bankruptcy filings to their jurisdiction. Corporate management typically makes the decision to file for bankruptcy, and it has discretion about where to file. Essentially, since the 1980s large public firms have been able to "forum shop" when they filed. Big filings mean big fees (see LoPucki and Doherty 2008), lots of activity for local attorneys, high prestige cases for judges, and so some courts deliberately tried to attract debtors-in-possession. The jurisdictional interests of the

[10] This was partly driven by nationalistic sensibilities that worried about foreign investors who were going to acquire national assets at "fire sale" prices. Like U.S. banks today, Indonesian firms argued that their assets were "unfairly" and "inaccurately" undervalued because of a temporary liquidity crisis.

local bankruptcy bar led to varying de facto meanings derived from the same legal text – the U.S. bankruptcy code. In this instance, a uniform legal text did not guarantee uniform legal interpretations. These local and competing legal communities (LoPucki particularly singles out Delaware and New York) are bound together by informal social ties that link judges, attorneys, and court clerks.[11]

The result of this competition was a "race to the bottom," under the umbrella of a single law. When they happen, regulatory races usually occur in the open, as different jurisdictions revise their formal regulations, either up or down, in response to regulations in competing jurisdictions, and the threat of business exit. Here, the implementation race occurred largely under cover and involved competing interpretations of bankruptcy procedure and substance that was ostensibly unitary.[12]

According to LoPucki (2005) and LoPucki and Doherty (2006), the outcome of this particular race has not been good. The result was implementation of bankruptcy rules that for large corporate bankruptcies skewed in favor of debtors-in-possession. By so favoring debtors, the Delaware bankruptcy court has over the 1990s successfully attracted more and more large corporate bankruptcies, but the chapter 11 reorganization filings made in Delaware have "failed" at a high rate (i.e., a high proportion of firms were back in bankruptcy court within 5 years of the original filing). Indeed, the failure rate is much higher than for other bankruptcy courts over the same period of time. LoPucki (2005) suggests that recurrent failure stems from the willingness of Delaware judges to provide

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[11] In some ways, the situation today is reminiscent of how local bankruptcy bars were characterized, and criticized, in the 1973 Bankruptcy Commission report (the so-called "bankruptcy rings").

[12] Drawing on Carruthers and Lamoreaux (2009), it is significant that the cost to a firm of shifting its bankruptcy filing from one state to another is relatively trivial, and so firms can be very responsive to whatever gains they receive from making such a shift. Such configurations often produce regulatory races, and that seems to be the case here, too.

quick approval to the simple but ineffective reorganization plans favored by debtors-in-possession. Delaware judges also sanction payment of high professionals' fees and tend to keep incumbent management in place.

A similar point is underscored in Hansen and Hansen's (2005) discussion of the evolution of U.S. bankruptcy law in the early 20th century. Although the 1898 law was intended to provide a framework for business failure, during the interwar years, as a growing amount of consumer credit was extended to U.S. households to finance purchases of durable goods, automobiles and homes, the law switched emphasis in its application away from businesses and towards households. In effect, the same law was used in very different ways. The relative proportion of wage earner bankruptcies climbed while that of business bankruptcies declined (Hansen and Hansen 2005: 19). Furthermore, the overall number of bankruptcy cases grew and this led to the development of a specialized bankruptcy bar. Henceforth, bankruptcy lawyers and judges were very active interest groups where bankruptcy law reform was concerned. This was clearly true later on in the politics of the 1978 Bankruptcy Act, where the jurisdictional interests of lawyers and judges weighed heavily (Carruthers and Halliday 1998), and is a factor in the competition decried by LoPucki (2005).

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Conclusion:

Moments of crisis create political opportunities for thorough-going reform that sets the stage for the subsequent period. In the U.S. during the 19th-century, bankruptcy laws were almost always put in place during an economic crisis, as debtors' political demands for relief produced a legal response. We are now in a period of crisis, and the

combination of widespread insolvency among firms and high numbers of personal bankruptcy filings will create political pressure to reform U.S. bankruptcy law. At the very least, bankruptcy will be in the spotlight for a time. Laws that do not protect or accommodate debtors will come under serious pressure during economic crisis simply because of the political clout of debtors. Furthermore, if insolvency is systemic, there is a prospect of bankruptcy courts being overwhelmed by the complexity and numbers of filings. However the substantive and procedural rules of bankruptcy law get modified, the effect of legal change will be magnified by the frequency with which bargaining between debtors and creditors occurs "in the shadow of the law."

This brief and necessarily selective discussion of corporate bankruptcy raises a couple of general issues that would-be reformers should be mindful of. First, the comparative and historical evidence on the implementation of bankruptcy law suggests that a serious gap can open between law-on-the-books and law-in-action. The practical effect of bankruptcy law may be sharply discrepant from the intended effects, as originally envisioned by rule-makers. However tempting it is to recognize a problem, revise legislation, declare "mission accomplished," and then move on to other matters, over the medium-term reformers should maintain their focus on implementation as the law "settles."[13] Implementation is clearly an important, if often unsung (and understudied), component of reform.

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A second, related point concerns why the gap between rule and implementation opens up. It is not simply that well-intentioned reformers are, like everyone else, subject to bounded rationality in the face of intractable uncertainties. Implementation gaps also open as the interests of rule-implementers come into play. Those who animate and

[13] Patashnik (2008) considers the related problem of why some reforms "work" and others do not.

operate the institutional machinery of bankruptcy have their own concerns independent from those of rule-makers and ruler-takers. Through “creative compliance” rule-implementers can push the rules in directions unforeseen by rule-makers. But rule-implementers are frequently overlooked when reformers think about rule-design and the impact on rule-takers.

Implementation gaps can arise out of a process that parallels “regulatory races.” Carruthers and Lamoreaux (2009) point out that regulatory races are most likely to occur when location is largely a legal matter with few physical entailments. That is, regulatory competition between different jurisdictions is more intense when firms can simply move their corporate charter from one state to the next, as opposed to moving their entire physical operation. The easier it is for firms to exit, the more sensitive they become to regulatory differences. Similarly, where a firm files for bankruptcy is a legal decision, largely unconstrained by where the firm is actually headquartered, or where its physical plant is located. LoPucki (2005) suggests that different bankruptcy courts have competed with each other to attract large corporate bankruptcy filings, and so gain from the activity, fees and prestige that follow. They compete not by offering “attractive” regulatory rules but through “attractive” implementation of the same set of bankruptcy rules. These “implementation races” can drive de facto rules in a direction quite unintended by the architects of the de jure rules.

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If it is predictable that new rules will generate unpredicted outcomes, then rule-makers should find some way to adapt to what they didn’t anticipated. This falls under the category of learning: can rule-makers design a rule that operates for a time and then is subject to modification in light of how it operated? Organizations that operate in highly

dynamic or uncertain environments necessarily develop protocols for organizational learning, and may offer insights applicable to the issue at hand.

Finally, business bankruptcy is an unpopular outcome (except, perhaps, to fully secured creditors). Because of when it happens (with the highest frequency during recessions) and why (due to firm failure) the bankruptcy system has to deal with problems that have no easy solution. Bankruptcy occurs when a firm has not or cannot live up to its contractual obligations, and the result is bound to make someone unhappy. The losses sustained by the debtor firm get passed on to others. If bankruptcy were a purely economic phenomenon, it might be fine to have bankruptcy laws that largely ignored the unpopularity of bankruptcy. But in a capitalist democracy, economic outcomes have political consequences, and political outcomes have economic consequences. Citizens' political support for capitalism depends on capitalism "delivering the goods," even when things aren't going well. Many countries have developed a variety of safety nets to protect their citizens from some of the risks associated with competitive markets. One of those risks is insolvency. Another is unemployment. Safety nets protect people from markets, but they also protect competitive markets by giving them political cover. This means that during hard times a bankruptcy law that too stridently upholds the sanctity of contracts, privileges debtors' prior obligations to creditors above all else, or generates starkly inequitable redistributions, will likely engender a political response. Bankruptcy law deals with economic problems, to be sure, but it also handles a larger political problem: how to treat failure in a way that doesn't diminish people's overall support for a market economy.

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Failure is a "normal" feature in competitive markets. There are winners and losers, and polities develop bankruptcy rules to deal with the losers. But the larger political problem varies depending on whether failure is ordinary or systemic. Ordinary failure is unfortunate, but tolerable. Some creditors will lose their money, some employees will lose their jobs, but the market goes on. When failure becomes systemic, however, ordinary bankruptcy rules are not adequate. When too many firms fail, too many creditors lose their money, or too many people lose their jobs, then failure cascades right through the entire market. Fortunately, there are other ways to deal with failure, and so polities are not without options. These other options, which may include dramatic measures like nationalization, will be more obviously "political" and ad hoc than routine application of bankruptcy rules. But to the extent that they allow the economy to continue to "deliver the goods," they help maintain political support for capitalism. In this sense, then, there is a parallel between reorganization of an insolvent individual firm and systemic insolvency across an entire economy. Successfully reorganizing a firm means breaching, modifying or reconfiguring the nexus of contracts at the core of the firm in such a way as to make flexible what had been rigid commitments. Similarly, to deal with systemic insolvency, political leaders may have to breach, modify or reconfigure the nexus of rules at the core of a market economy in order to make flexible what was rigid and failing.

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