A comparative study of the corporate bankruptcy reorganization law of the U.S. and China
Ren, Yongqing

IMPORTANT NOTE: You are advised to consult the publisher's version (publisher's PDF) if you wish to cite from it. Please check the document version below.

Document Version
Publisher's PDF, also known as Version of record

Publication date:
2011

Link to publication in University of Groningen/UMCG research database

Citation for published version (APA):

Copyright
Other than for strictly personal use, it is not permitted to download or to forward/distribute the text or part of it without the consent of the author(s) and/or copyright holder(s), unless the work is under an open content license (like Creative Commons).

Take-down policy
If you believe that this document breaches copyright please contact us providing details, and we will remove access to the work immediately and investigate your claim.

Downloaded from the University of Groningen/UMCG research database (Pure): http://www.rug.nl/research/portal. For technical reasons the number of authors shown on this cover page is limited to 10 maximum.

Download date: 29-05-2019
2 Bankruptcy Jurisprudence theory: Comparison and Choice

Before analyzing the bankruptcy reorganization law of a specific country in detail, we need to clarify the goal or the function of the bankruptcy reorganization law. Different bankruptcy theories have different opinions concerning the goal or function of bankruptcy reorganization law. These theories may be generally divided into two groups. The first group takes the goal of bankruptcy reorganization law as the maximization of the debtor’s economic value, while the second group considers that the goal is to protect the debtor’s diversified values or to provide ideal protection for all the parties affected or the values held by the affected parties. A brief analysis and comparison of the representing theories, i.e. the creditors’ bargain theory, the bankruptcy policy theory, the value-based theory, the risk-sharing theory, and the team production theory of bankruptcy reorganization is made below.

2.1.1 Creditors’ Bargain Theory

Thomas H. Jackson proposed the creditors’ bargain theory in the early 1980s and subsequently, Douglas G. Baird joined him as the main proponent of the creditors’ bargain theory. Ever since its publication, the creditors’ bargain theory has caused heated debate and been the focus of much attention. It became the most influential law and economics theory concerning bankruptcy law.


2.1.1.1 The Goal of Bankruptcy Law

The creditors’ bargain theory aims at providing a normative theory of what bankruptcy law should be, instead of trying to provide a normative justification of the bankruptcy law that already exists in practice. It explains the goal of bankruptcy law or why bankruptcy reorganization law exists, through the perspective of a “hypothetical bargain”. Suppose that the debtor and its creditors were rational and able to bargain among themselves ex ante, they would agree to restrain their individual collection actions and adopt a mandatory and collective bankruptcy procedure. The reasons why the debtor and creditors would choose a mandatory and collective procedure can be summarized as that the collective procedure helps to maximize the debtor’s value and minimize the costs of debt-collection. Detailed analysis is below.

1) Reduction of strategic costs

Absent cooperation among creditors, each creditor would have the incentive to pursue individual collection before the other creditors, thus creating a classic example of “common pool puzzle”. The “race to the courthouse” or the race to individual collection activities not only incurs high costs (such as costs caused by frequent checking of the collection lawsuit against the debtor by other creditors, vigilant monitoring of the debtor’s financial status and payment ability, competing with other creditors in trying to get the necessary information) for individual creditors, but may also lead to a premature termination of a debtor’s business. These strategic costs may be reduced by an ex ante agreement on a compulsory collective bankruptcy procedure.

2) Administrative efficiencies

“Issues such as the precise amount of the debtor’s assets and the nature and extent of secured claims must be solved in virtually every collection procedure.” “A single inquiry into recurring collection questions is likely to be less expensive than the multiple inquiries necessary in an individualistic remedies system,” since a single mandatory and collective

---


60 Id, p. 866.
procedure may help to avoid the recurring costs and case management inefficiency under the individual collection system to the common interests of the debtor and all its creditors.  

3) Maximization of the debtor’s overall economic value

In some cases, the debtor’s assets may be worth more if kept together, whether in the form of going-concern liquidation or reorganization, than in the case of a piecemeal liquidation. Under the individual collection system, a creditor will try to be the first to collect payment from the debtor. If the debtor and its creditors could bargain ex ante, they would choose to have a compulsory collective procedure, in which they could act as if they were the one owner of the assets and try to find a way of realizing the highest economic value of the debtor’s assets, which may be piecemeal liquidation, going-concern liquidation or reorganization.

According to the creditors’ bargain theory, bankruptcy reorganization is an equal alternative to liquidation. Market pricing does not always work well. Sometimes a going-concern sale to third parties may result in a price which is lower than the price at which the existing claimholders value the bankruptcy assets. This may be because “there were no or few potential outside buyers with accurate and timely information about the true state of affairs and future prospects of the business or when the process of searching for and educating outside buyers would itself be very expensive.”

In this situation, reorganization is needed in order to help the claimholders to realize the highest value from the bankruptcy assets. The principal distinction between reorganization and liquidation is not that the assets are kept together in reorganization, since the assets can be kept together in a going-concern liquidation sale to a third party. The key distinction is who the buyers are: third parties or former claimants. Under the liquidation procedure, the assets are actually sold to third parties. Under reorganization, the assets are sold as a going-concern to the existing claimholders themselves because the assets are worth more to them than to third parties. Therefore, the bankruptcy reorganization law exists simply to realize the goal of the maximization of the debtor’s overall economic value.

---

61 Id, pp. 866-8.
62 Id, pp. 864-5.
64 Thomas H. Jackson (2001), The Logic and Limits of Bankruptcy Law, Bear Books, p. 211.
4) Preserving the benefits of the collective procedure: including secured creditors in the collective procedure.

Compared with unsecured creditors, secured creditors are not direct beneficiaries of the “reduction of strategic costs” or the “maximization of the value of the debtor’s assets” advantages of a collective procedure. They are less likely to view the “administrative efficiencies” as special benefits since the difficult administrative issues, such as the availability of assets and the priorities of competing claimants, may have often been previously negotiated and the cost in realizing the security is often contractually allocated to the debtor. However, if secured creditors could remove the collateral from the debtor, the going-concern value that comes from the debtor’s aggregate pool of assets cannot be preserved, which means that the advantages of the collective procedure are being diminished or lost. Therefore, under the condition that “secured creditors are left as well off as outside bankruptcy”, they have no reason to object to being included in the collective procedure.65

To summarize, because of the reasons discussed above, we would expect that the debtor and all the creditors would agree to replace the individual remedies system with a mandatory and collective bankruptcy procedure, in which the collection costs are best minimized and the value of the debtor’s assets is maximized. Although a real ex anti negotiation among all the creditors and the debtor will not happen because of problems, such as the bounded rationality of the creditors, the great difficulty and high costs in making an agreement which provides comprehensive, scientific and optimal arrangement on all the related matters, the high costs in organizing such a complex negotiation, and the fact that the creditors of a debtor are changing over time, the legislation body may solve these problems by making available a mandatory and collective procedure in bankruptcy context. In a word, bankruptcy law exists “as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an ex ante position”,66 and bankruptcy reorganization law exists just for the goal of the maximization of the debtor’s overall economic value.

2.1.1.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors

The creditors’ bargain theory posits three principles with respect to the relationship of bankruptcy law and protection of non-investors. Detailed analysis is below.

1) Bankruptcy law should respect non-bankruptcy law.

Even if a non-bankruptcy rule is substantively inefficient or inequitable and changing the rule within bankruptcy might result in overall improvement in efficiency and equity of bankruptcy procedure, this would be less preferable and the second best solution because of the following three reasons.

First, because the rule is not a bankruptcy rule, changing it into only bankruptcy will confuse the distinction between bankruptcy law and non-bankruptcy law and obscure the unique function of bankruptcy.

Second, changing the rule into only bankruptcy is an incomplete or partial solution. This incomplete solution masks the fundamental necessity of making a general rule change by the Congress, which should be the best way of finding a solution that keeps the relationship between the non-bankruptcy and bankruptcy law clear and ordered.

Third, changing the rule only within a bankruptcy context means wealth redistribution or creating a set of entitlements in bankruptcy different from those that exist outside of bankruptcy, which will cause the undesirable effect—forum shopping. The interested parties who are advantaged by the distinct bankruptcy rule will try to use the bankruptcy process to get their individual benefits even when it is not in the collective interests of all the claimholders as a whole, while the parties who are disadvantaged by the bankruptcy rules will try to prevent the use of the bankruptcy procedure even if using bankruptcy procedure is in the collective interests of all the interested parties.

The creditors’ bargain theory asserts that bankruptcy law should fully respect the interested

---

67 The term “non-investors” means those who do not hold a legal claim against the bankruptcy estate according to non-bankruptcy law. These non-investors hold some value or interest that is not a non-bankruptcy right to payment or a non-bankruptcy claim, but may be affected by the business failure, such as a worker’s employment opportunity, the interest of a certain affected community that may be hurt by the failed enterprise.


69 Id, p. 730.
parties’ non-bankruptcy entitlement and the wealth distribution order established by non-bankruptcy law in order to avoid wealth redistribution in bankruptcy and forum shopping. The creditors’ bargain theory emphasizes that how to establish an appropriate wealth distribution priority order should be “a question of the law generally” instead of being a question “peculiar to the bankruptcy law”. The creditor’s bargain theory proposes that wealth distribution should be dealt with within the context of the whole legal system. Bankruptcy law should honor the wealth distribution order in bankruptcy law and set up a wealth distribution order which is the same as that in the non-bankruptcy law so that there will be no forum-shopping between non-bankruptcy and bankruptcy procedures and a value or interest will be protected in a unified way inside and outside bankruptcy. Baird stated that “[l]egal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them. Whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy.” Baird took the retiree health benefits claims as an example. He argued that if we intend to protect the retiree’s health benefits claims against a corporation, we should establish relevant rules in the non-bankruptcy law, which is ERISA (Employee Retirement Income Security Act) in the US. Since firms may close without defaulting to creditors or without bankruptcy petition, solving the problem only within bankruptcy law, i.e. providing retiree health benefits claims a special priority level, does not provide a complete and uniform solution while creating a forum-shopping problem.

2) Bankruptcy law interferes with non-bankruptcy rules or creditors’ non-bankruptcy rights only when fully recognizing that those rules or rights hinder the operation of the collective procedure and the extent of that interference is limited by the necessity for preserving the benefits of the collective procedure.

The collective procedure sometimes requires the interference with non-bankruptcy rights. In these situations, we must weigh the damage that keeping a non-bankruptcy right unchanged in bankruptcy would inflict upon the collective procedure against the undesirable effects created.

71 Id, p. 822.
72 Id, pp. 828-31.
by changing that right. Only if the damage to the collective procedure is higher, can bankruptcy law change the non-bankruptcy right. In some cases (such as automatic stay of security rights), inferring with the right does not require interfering with the value of the right. In other cases (such as preferences avoidance), the value of the right is disregarded by the bankruptcy law. In either case, at bottom, the preempting rule that determines whether to modify a non-bankruptcy entitlement and how to modify a non-bankruptcy entitlement is derived from the fundamental reason of bankruptcy law’s existence, i.e. the necessity of replacing an individual remedies system with a collective procedure. Therefore, preserving the benefits of the collective procedure is the only justification for interfering with non-bankruptcy rights.

3) Bankruptcy law should not take the protection of non-investors as its goal. Starting from the point that bankruptcy law should try to respect non-bankruptcy law and avoid wealth redistribution in bankruptcy, the creditors’ bargain theory is opposed to the idea that bankruptcy law should take the responsibility of protecting the rights of non-investors, i.e. parties whose interests are affected by the business failure but who do not have a legal claim against the debtor’s assets according to non-bankruptcy law. Baird argued that: “[b]usiness ‘failure’ is not necessarily connected with default. Moreover, default itself is not necessarily connected with bankruptcy. Anytime resources are shifted from one use to another, or from one place to another, there are likely to be spill-over effects—both positive and negative.” There is no sufficient reason why it is appropriate only to tackle the outside effect of business change within bankruptcy law. If some interests need to be protected, it is better to tackle this problem and provide protection within the whole legal system in order to provide a uniform and certain protection. To provide special non-investor protection within bankruptcy would create wealth redistribution in bankruptcy, which may cause the forum shopping problem.

75 Id, p. 829.
76 Baird stated that “[l]egal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them. Whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy.” Douglas G. Baird (1987), Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815, p. 822.
77 Id, pp. 828-9.
2.1.2 Bankruptcy-policy Theory

In response to the creditors’ bargain theory, Elizabeth Warren proposed a bankruptcy-policy theory, through which she tried to highlight the limited explaining power of the law and economics account of bankruptcy law.\(^{78}\)

2.1.2.1 The Goal of Bankruptcy Law

Warren criticized that the creditors’ bargain theory provides a “narrow” explanation and “negates a realistic appraisal of the bankruptcy system”.\(^{79}\) Warren argued that economic value enhancement is only part of the goal of bankruptcy law.\(^{80}\) She stated that her bankruptcy theory is to give “a comprehensive statement about the various and competing goals that underlie the bankruptcy system” so as to provide useful assistance to the legislative and judicial decision-making.\(^{81}\) Generally, Elizabeth Warren held that bankruptcy law is a debt collection scheme for distributing the wealth among the competing claimholders and dealing with the broad effect of business failure in the context of the debtor’s imminent collapse, or a

---

\(^{78}\) The main content of bankruptcy policy theory is discussed in the these articles: Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775 and Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336.

\(^{79}\) “The policies we embrace and the models we use to describe the system animate our vision of how the system operates and our conclusions about its successes and failures. If the inquiry over bankruptcy policy becomes nothing more than a debate over allocative efficiency, it will pass over crucial elements of the policy scheme that cannot be so neatly tied up in economic models. An approach that eschews any role for efficiency analysis suffers a similar fate, creating an economic versus noneconomic dichotomy that negates a realistic appraisal of the bankruptcy system.” Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, p. 338.

\(^{80}\) “[T]he value-enhancement principle is sufficiently well accepted....., however, a more complete elaboration of a bankruptcy policy may change how a problem is framed or what solutions are proposed.” Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, p. 373.

\(^{81}\) This essay is about bankruptcy policy. It attempts to articulate a comprehensive statement about the various and competing goals that underlie the bankruptcy system. The essay offers both a positive observation, drawn from the Code and its operation, and a normative evaluation, designed to outline the difficult value judgments that comprise the bankruptcy system. It also serves warning: before commentators propose any sweeping changes or policymakers take seriously any suggestions to scrap the system, they must consider the impact of such proposals on a number of competing normative goals.” Elizabeth Warren (1993), Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, p. 338. “I begin with a historical observation about legal structures, I surmise the concerns of the drafters, and I end with tentative conclusions and more complex questions.” Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775, pp.777-8. “I have not offered a single-rationale policy that compels solutions in particular cases....I have only identified normative considerations that may drive legislative and judicial decisions.” Id, at 795-6. “A policy that focuses on the values to be protected in a bankruptcy distribution scheme and on the effective implementation of these values assists the decision-making process even if it does not dictate specific answers.” Id, at 796. “Baird’s view is more chic than mine, but I believe my view is more realistic and more likely to yield useful analysis.” Id, at 811.
debt collection law for protecting the values affected in the context of business failure. In an attempt to make a clear articulation of the goal of bankruptcy law, Warren summarized that bankruptcy law has four principal goals: “foster[ing] substantial enhancement of the value of the debtor, so that parties receive more than they would under alternative collection systems”; “distribut[ing] those assets according to a deliberate scheme, offering protection to a number of deserving parties who would otherwise receive little”; “forc[ing] parties who deal with the debtor to bear the burden of their losses without externalizing them to others”; establish[ing] a mechanism that can “bring the [bankruptcy] system into play at the appropriate time”.

2.1.2.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors

According to the bankruptcy-policy theory, bankruptcy law can alter the interested parties’ non-bankruptcy right and there can be wealth redistribution in bankruptcy because bankruptcy and non-bankruptcy law deal with different kinds of default. Warren argues that bankruptcy law provides a collection scheme that operates in a unique context. She noticed that there are “two prototypes of default: first, the single default where only one creditor complains about repayment and the remaining creditors are evidently (even if only temporarily) content with their repayment prospects; and second, the debtor’s widespread default and collapse in which every creditors’ prospects for payment are sharply diminished.”

While non-bankruptcy law provides a collection scheme that copes with the first kind of default or limited default, the bankruptcy collection scheme “concentrates on the default of the debtor’s imminent

---

82 Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775, pp. 785-97. “I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing-and sometimes conflicting-values in this distribution. As I see it, no one value dominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, ‘How shall the losses be distributed?’” Id, p. 777. Warren listed some values affected in the business failure, such as the protection of payment to the wage claims, of the workers’ employment opportunities, of the survival opportunity to a failed business. She commented that “[t]he list offered here is preliminary at best, and any example given undoubtedly could be explained by several distributional rationales. The point of this paper, however, is not to explore every value weighed in bankruptcy's distributional scheme, but to establish that such values exist, that Congress gives them credence, and that collectively they have a significant impact on the bankruptcy process.” Id, at 793.


collapse". Since non-bankruptcy and bankruptcy law deal with different situations, they should adopt different distributive schemes. Under the bankruptcy-policy theory, bankruptcy law aims at providing appropriate protection to the different parties or values affected by the business failure through its specific distribution rules. “Distribution among creditors is not incidental to other concerns; it is the center of the bankruptcy scheme.” According to the bankruptcy-policy theory, the creditors’ bargain theory, by proposing bankruptcy law should adopt the distribution order established under non-bankruptcy law, actually adopts the distributional scheme under non-bankruptcy law without inquiring into its appropriateness. On the ground that bankruptcy and non-bankruptcy law deal with different kinds of default, the bankruptcy-policy theory claims that bankruptcy and non-bankruptcy law differ “in their central policy considerations because they rest on fundamentally different premises.” “To structure collection rules and priorities in the context of inextinguishable claims is to create one kind of system. To craft that set of collection rules and priorities onto a system that discharges debt is to create a very different collection system—one that should be evaluated separately and not accepted simply because some of the rules make sense in a different, state law scheme.”

Warren listed a series of distributive rationales of bankruptcy law, such as favoring creditors whose ability to bear the cost of default is relatively weak, preventing pre-bankruptcy transactions based on perverse incentives, treating like creditors alike, forcing shareholders to bear the loss of business failure, benefiting the whole bankruptcy estate by helping the business to survive. However, Warren also pointed out that the distributive goals may conflict with each other and it is difficult or even impossible to provide a consistent answer to questions such as how to reallocate the resources and how to solve the conflict between the different distributive goals. Warren stated that although she has “identified the distributional rationale of bankruptcy”, there is still a need to explore the detailed policies or normative

---

85 Id, pp. 781-2.
86 Id, pp. 785-97.
87 Id, p. 785.
88 Id, pp. 789-90.
89 Id, p. 784.
90 Id, p. 785.
91 Id, pp. 790-3.
basis of an optimal bankruptcy distributional scheme.\textsuperscript{93}

According to bankruptcy-policy theory, protection of non-investors is an element of the wealth redistribution in bankruptcy, since bankruptcy is “an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing-and sometimes conflicting-values in this distribution”.\textsuperscript{94} Warren asserted that “bankruptcy policy also takes into account the distributional impact of a business failure on parties who are not creditors and who have no formal legal rights to the assets of the business.”\textsuperscript{95} For instance, “[the] Code accounts for the rights of other parties that a business failure affects by giving a failing company an opportunity to sell itself as a going concern in Chapter 7 or to reorganize in Chapter 11.”\textsuperscript{96} Moreover, Warren pointed out that “[t]he protection offered to parties without formal rights may be indirect and incomplete, but that does not mean that such factors are—or should be—irrelevant to policymaking.”\textsuperscript{97}

2.1.3 Value-Based Theory

Donald R. Korobkin proposed the value-based theory which tries to give a rich and full explanation to the question why bankruptcy law emerged as a system with the varied contours and dimensions that it has.\textsuperscript{98}

2.1.3.1 Goal of Bankruptcy Law

The value-based theory objects to considering the debtor as merely a pool of assets, i.e. dead property and emphasizes that the debtor has personality and dynamic potential, and like a natural person debtor, is a moral, political and social actor. The value-based theory compares the progress of the debtor’s estate with that of a human life. Just as the decision on what is

\textsuperscript{93} Elizabeth Warren (1987), Bankruptcy Policy, 54 U. Chi. L. Rev. 775, pp. 795-6.
\textsuperscript{96} Id, at 355.
“good” for a human can not be made once and for all, there is no fixed answer as to what is
the good solution to a debtor’s financial distress, since every financial distress is in a specific
historical context and contains particular questions. Bankruptcy law is a full response to all
the problems arising from the financial distress, not only economic but also moral, political,
personal and social. The problems arising from financial distress are so complicated that the
answer should be left to the participants representing conflicting and fundamentally
incommensurable values, who will finally find the answer to the changing questions in
historically situated contexts.

The value-based theory concluded that bankruptcy law is not merely a response to the
problem of collecting debt, and the goal of bankruptcy law is to “address the problems of
financial distress and to create conditions for a discourse in which values of participants may
be rehabilitated into a coherent and informed vision of what the enterprise shall exist to
do.” Correspondingly, bankruptcy reorganization law is to rehabilitate and redefine the
values of the debtor into a “coherent new version of what the enterprise shall exist to do.”

What kind of value-protection scheme should be achieved? How can the bankruptcy
decisions be made? “[B]ankruptcy law frames decision making in a way that allows a full
response to the problem of financial distress. Historically situated participants express
conflicting and fundamentally incommensurable values; they make decisions based on the
possible visions of the enterprise that exist--or that may be invented--at a particular moment
in the case.”

To put it concisely, the value-based theory asserts that bankruptcy involves complicated problems and the answer to these problems should be open.

2.1.3.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth

---

99 Id, pp. 744-5; 768.
100 Id, p. 766-8.
101 Id, p. 766.
102 Id, p. 789. “[T]he success of a bankruptcy case, whether it ends in reorganization or liquidation,
must be evaluated in more comprehensive, yet perhaps more problematic, terms: in what ways has the
bankruptcy case caused a rehabilitation of the values of its participants, and to what extent has there
emerged out of bankruptcy an informed and coherent vision of the aims of the enterprise.” Id, p. 774.
103 Id, p. 773-4.
104 Id, p. 788.
105 Id, p. 789.
Redistribution and Protection of Non-investors

Since the value-based theory takes the protection of the values affected in every specific business failure case as the goal of bankruptcy, it supports alteration of the interested parties’ non-bankruptcy rights, wealth redistribution in bankruptcy and protection of non-investors that are the result of the “rational debate” of the participating parties of a specific bankruptcy case. The value-based theory claims that “in responding to financial distress, bankruptcy law sometimes should and must alter rights recognized under substantive nonbankruptcy law. This is not a forbidden act, as the economic account suggests; it is an essential and inevitable part of a full response to the problem of financial distress.” “There may be good economic and noneconomic reasons for preserving state law entitlements, but in specific contexts, there will be compelling reasons to change them.” Whether or not to change non-bankruptcy entitlements is a complicated question and requires serious discussion among all those who will be affected by the outcome. “The debate on this question is the kind of debate that bankruptcy law is uniquely structured to offer.” To summarize, under the value-based theory, bankruptcy decisions are the result of a rational debate, which may include alteration of non-bankruptcy rights and promotion of noneconomic values.

The value-based theory supports protection of non-investors in bankruptcy. The proponent of the value-based theory commented that the economic account of bankruptcy law undermines the explanation of the bankruptcy system since it only recognizes economic values involved in the financial distress of a debtor corporation. In sharp contrast to the economic account of bankruptcy law, the value-based theory recognizes all the values affected in a bankruptcy case, not only the economic value, but also the moral, political and social values. Obviously, under...

106 Id, p. 789; 768.
107 Id, p. 768.
108 Id.
109 Id, p.768.
110 Id, p.789.

"'The challenge facing anyone who wants to write about bankruptcy policy,' Professor Baird has stated, 'is to explain why a distinct bankruptcy law exists at all.' The value-based account explains bankruptcy law as existing to address the problem of financial distress and as creating conditions for a discourse in which values of participants may be rehabilitated into a coherent and informed vision of what the enterprise shall exist to do. Because the value-based account does provide an answer, albeit a preliminary one, to Baird's question, we are free, once again, to 'write about bankruptcy policy.'" Id, at 788-9. "We are no longer barred--as the economic account would bar us--from urging changes that alter substantive nonbankruptcy rights or that promote noneconomic outcomes as independent values. At times, we will urge such changes, at other times, we will not. In any event, we are free to engage in rational debate. For the value-based account releases us, in writing about bankruptcy policy, to acknowledge the diverse values that find expression in financial distress." Id, p. 789.
the value-based theory, the values to be protected include values held by formal investors but also values held by non-investors.\textsuperscript{111}

### 2.1.4 Risk-Sharing Theory

The risk-sharing theory is proposed by Thomas H. Jackson and Robert E. Scott in an attempt to provide normative justification of the redistributive provisions in bankruptcy law. Because it is basically a modified version of the creditors’ bargain theory, the risk-sharing theory is called by the proponents as “an expanded model of the creditors’ bargain”.\textsuperscript{112}

#### 2.1.4.1 Goal of Bankruptcy Law

Risk-sharing theorists noticed that bankruptcy law deviates from the creditors’ bargain theory in that it contains wealth redistribution or reallocation provisions. In trying to justify the wealth redistribution provisions contained in bankruptcy law, they proposed the risk-sharing theory. According to the risk-sharing theory, bankruptcy law has a central goal of maximizing the debtor’s overall value and a complementary goal of forcing all claimholders to “share (at least in part) the ‘common’ risks of business failure”.\textsuperscript{113} Risk-sharing theorists explained that all the investors of the debtor would have agreed to a commonly beneficial risk-sharing agreement to deal with the risk of loss from the debtor’s insolvency were they able to negotiate. Since the negotiation could not really happen because of the prohibitively high transaction costs, the bankruptcy wealth redistribution provisions serve as what the risk-sharing agreement would have provided.\textsuperscript{114} All the investors of a debtor would prefer a risk-sharing agreement, because of the following reasons:

1) Sharing common risks

Risk-sharing theory proposes that besides the central goal of maximizing the value of the debtor’s assets, bankruptcy law should have a complementary distributional goal, which is that “all participants should share (at least in part) in the ‘common’ risks of business failure”.

\textsuperscript{111} Id.


\textsuperscript{113} Id, p. 164.

The term “common risks” is defined in comparison with the term “particular risks”. Common risks are the risks of loss from “exogenous” sources beyond management’s control, such as the general downturn of an industry or of the overall economy. In contrast, particular risks are the risks from “endogenous” sources, i.e. the risk of loss due to managerial misbehavior, managerial preference for risk etc.\textsuperscript{115}

Risk-sharing theory holds that because some individual group is the best able to monitor or control the particular risks, the parties would bargain for bearing the particular risks individually. For example, the parties would agree that shareholders should bear the risks arising out of incompetent or dishonest management, since shareholders stand in the best position for monitoring the firm’s managers’ performance.\textsuperscript{116} In relation to common risks, the hypothetical bargain result would be different. Because no individual group can control common risks and all investors are risk averse, they would bargain to share the common risks because a risk-sharing arrangement reduces the risk and ensures that each party has a higher probability of incurring a smaller loss. “[P]arties to a creditors’ bargain would adopt a mixed strategy of bearing risk. Individualized strategies designed to reduce risk are generally preferred, but some form of risk sharing would be adopted for those common perils that are too uncertain and interactive to make individual action meaningful.” \textsuperscript{117} As a result of sharing common-risks, bankruptcy law does not absolutely respect non-bankruptcy entitlements, but contains some redistributive provisions. For instance, allowing the bankruptcy trustee to decide whether to assume or reject executory contracts, imposing delay interest on secured creditors, providing the debtor with a generous opportunity for rehabilitation, are wealth redistribution provisions contained in bankruptcy law as a result of risk sharing.\textsuperscript{118}

2) Mitigating eve-of-bankruptcy conflict and securing cooperative incentives

On the eve of bankruptcy, the parties may have perverse incentives. Firstly, an individual creditor may engage in a destructive race for debt-collection, which may cause dissipation of the debtor’s business. Moreover, those who have de facto control over a debtor’s decision-making will have an incentive to make decisions that favor themselves but are


\textsuperscript{116} Id, p.164.

\textsuperscript{117} Id, p.167.

\textsuperscript{118} Id, p.185; 189-90; 192.
harmful to the interests of the claimants as a group. For instance, creditors, who have a special relationship with the debtor’s management, may receive payment in a favored way. Wealth redistribution provisions, such as bankruptcy provisions that restrain preferred payments and fraudulent conveyance, can help to solve this kind of problems. Secondly, equity holders and their agent—the management, have the incentive of delaying the bankruptcy petition. Risk-sharing agreement and the bankruptcy’s redistribution provisions, such as providing the debtor a generous opportunity for rehabilitation, imposing delay cost on secured creditors, can help to counteract this kind of perverse incentive and secure cooperative actions. Should the shareholders still acquire part of the assets based on risk-sharing, they and their agent would try to preserve the debtor’s value, since they are dealing with the assets that are related to the interests of not only the creditors but also the shareholders.  

3) Protecting firm-specific capital investments

Some shareholders or managers make firm-specific investments that cannot be evaluated in monetary or any other objective term. For example, in some small, closely held firms, the owner-managers make substantial non-pecuniary or sentimental investments. This firm-specific investment is essentially non-diversifiable and cannot be protected by a normal insurance method. Offering the firm a more generous opportunity for rehabilitation is a device for protecting the firm-specific investments.

4) Protecting victims of business failure who have no risk-reducing alternatives

Risk-sharing theorists tried to provide a normative justification for the distribution to non-investors. “Tort claimants, retired employees, residents of the community, and other affected third parties might be considered ‘victims’ of business failure and bankruptcy.” They stated that the non-investors “share an important quality with the victims of true disasters that may explain why such victims are the beneficiaries of distributions when catastrophe strikes”, which is that they do not have “risk-reducing alternatives, such as insurance, security, or other bonding mechanisms.” “Because these parties do not have an

---

119 Id, pp. 169-74.
120 Id, p.175.
121 Id, p. 177.
122 Id, p. 177.
opportunity to protect themselves with security, it can be argued that they ‘deserve’ a distribution of the assets in bankruptcy in the same way that flood victims deserve assistance.” 123

2.1.4.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors

As a theory for providing an explanation of the wealth redistribution provisions in the bankruptcy law, the risk-sharing theory accepts that bankruptcy law can, to a limited extent, deviate from the wealth distribution order established by non-bankruptcy law.124 Recall that in the creditor’s bargain theory, Jackson warned that wealth redistribution invites the perverse incentive of forum shopping. What did he say about the problem of forum shopping created by the wealth-redistribution rules in the risk-sharing theory? Jackson said that the irreducible cost of forum shopping is reasonable if it brings greater benefits.125 The risk-sharing theorists pointed out that whether the benefits of wealth redistribution exceed the corresponding cost remains to be an unsolved “empirical problem” and admitted that their theory “ultimately leaves unresolved the ongoing normative debate concerning the proper role for bankruptcy in the resolution of creditor claims.”126 Risk-sharing theory is different from the creditors’ bargain theory in that it takes wealth redistribution as a complimentary goal of bankruptcy law. Risk-sharing theory finds that four specific reasons may justify the wealth distribution provisions contained in bankruptcy law. Those four reasons are sharing common-risks, mitigating eve-of-bankruptcy conflict and securing cooperative actions, protecting firm-specific capital investments and protecting victims of business failure who have no risk-reducing alternatives.127 It should be noted that risk-sharing theorists proposed that the wealth redistribution rules should be designed in a way that may cause less rent-seeking behavior. They said that wealth redistribution in bankruptcy could be taken as “a bankruptcy tax imposed on the participants in the collective procedure.”128 It is better to make the tax

123 Id.
124 Id, pp. 156-8.
125 Id, p.198.
126 Id, p. 203.
127 See section 2.1.4.1.
128 Id, p. 204.
"certain and horizontally equitable". "The more the tax is made certain and horizontally equitable, the less individual parties will be motivated to escape their share of the distributional burden." If the bankruptcy redistribution rules are ambiguous and uncertain, which means that their application depends on the ex post evaluation of the particular facts of a specific case, the uncertainty would motivate wasteful rent-seeking behavior. For instance, "the claimants have an incentive to expend resources to minimize the incidence of the bankruptcy tax on them as individuals, thus reducing the wealth of the claimants as a group." Concerning the protection of non-investors, the risk-sharing theory’s conclusion is tentative. It proposes that bankruptcy law may provide protection of non-investors since they, like the victims of a flood, do not have risk-reducing alternatives. However, risk-sharing theorists noticed that “it may in some sense be analytically correct to suggest that the problems that animate distribution to nonconsensual victims of common disasters are not ‘bankruptcy’ problems.” “[T]he individual participants in the creditors' bargain would presumably be as willing to support these claimants as they would any other charitable cause. From the perspective of the collective, however, these forms of redistribution will be seen as costs of bankruptcy that will undermine, at least in part, the primary objectives of collectivization.” Anyway, risk-sharing theorists provided inspiration in explaining wealth redistribution to non-investors from the perspective of risk-sharing.

2.1.5 The Team Production Theory of Bankruptcy Reorganization

The team production theory of bankruptcy reorganization was proposed by LoPucki with the aim of establishing a theory of the bankruptcy reorganization law of public corporations by applying the team production theory of corporate law in the field of bankruptcy

---

129 Id, pp. 202-3. In order to give a clear explanation of the legislative suggestion, which is “making bankruptcy tax certain and horizontally equitable”, the risk-sharing theorists made further illustration. “This suggests that cross-the-board redistributions, such as the Timbers denial of postpetition interest for secured creditors, are preferable to the individualized distributional policies reflected in the Eighth Circuit’s decision in Ahlers.”
130 Id, at 202-4.
131 Id, at 177
132 Id, at 178.
133 Id.
reorganization.\textsuperscript{134}

\subsection*{2.1.5.1 The Goal of Bankruptcy Law}

The team production theory of bankruptcy reorganization is to provide a normative theory on bankruptcy reorganization law of public corporations by applying the team production theory of corporate law to the bankruptcy reorganization of public corporations.\textsuperscript{135} The team production theory of corporate law is based on the hypothesis that the constituent groups of public corporations, i.e. the “team”, deliberately delegate to the board of directors the ultimate authority over both the direction of the corporation and the distribution among team members of production rents and surpluses. Why would the team delegate this ultimate authority to the board of directors? The reason is that it is difficult or impossible to deal with these matters through explicit contracts in the changing and uncertain everyday business environment.\textsuperscript{136} Under the team production theory of corporate law, “the team members may include stockholders, creditors, executives, other employees, suppliers, customers, local governments, regulatory agencies, and others.”\textsuperscript{137} The team production theory of bankruptcy reorganization asserts that “the team production contract continues in force during bankruptcy reorganization. The rationale …. is that the team members intended that result at the time they contracted. Preservation of the firm’s going concern value usually requires that much of the team remain in place and continue to produce during a reorganization effort, but adjustments to the team production arrangement may be necessary. For example, the team may need to fire and replace its managers--or pay them bonuses to stay. Team members are not, however, in a position to negotiate the necessary adjustments. Many are already irrevocably committed to the firm. Instead, team members long before delegated the adjustment process to the discretion of the board.” According to the team production theory of bankruptcy reorganization, the bankruptcy reorganization law of public corporations is the expression of the hypothetical team production contract and its goal is “to serve the interests of all team

\textsuperscript{134} For the team production theory of corporate law, please see Margaret M. Blair and Lynn A. Stout (1999), A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247.
\textsuperscript{136} Id, pp. 749-54.
\textsuperscript{137} Id, p. 749.
2.1.5.2 The Relationship between Bankruptcy and Non-bankruptcy Law, Wealth Redistribution and Protection of Non-investors

According to the team production theory of bankruptcy reorganization, the team production contract gives the board complete freedom in dealing with the deployment problem and non-bankruptcy law entitlements. The team production theory of bankruptcy reorganization accepts that the creditors’ and shareholders’ non-bankruptcy entitlements may be changed and the wealth may be redistributed in bankruptcy. The team production theory holds that the board, just as outside of bankruptcy, remains in control after the firm enters into bankruptcy and has the authority of deciding how to treat the creditors’ and shareholders’ entitlements that are recognized by the non-bankruptcy law and the team members’ team entitlements’ that are not recognized by the non-bankruptcy law but as part of the team contract.

“Under the Team Production Theory, the bankrupt firm should honor its obligations to all who made firm-specific investments at the invitation of the firm and could not protect them in other ways….It might justify the retention of particular long-term employees, for example, despite the fact that others were now available to work more cheaply. It might justify the payment of ‘retention bonuses’ of the type that have recently become common in reorganization cases. It might also justify continuing to operate the business in a community where costs were higher than in some alternative location. The firm-specific investments so recognized might include the expenses incurred by employees and suppliers in moving to the community to join the team, or tax concessions made by the local taxing authority to attract the debtor to the community. They might also include the investments and efforts consumers of computer products make when they buy and learn to use products. In each of these cases, the firm invited the investment and the investor placed trust in the directors to reciprocate. Meeting these obligations does no violence to the rights of team members who do have legal rights against assets, because the holders of the legal rights have contracted that the

138 Id, p. 769.
139 Id, pp. 749-64.
obligations to the team be met.”"\textsuperscript{140} “The members of the board of directors, acting as fiduciaries, decide which of these claims to recognize and how much to pay the claim holders.”"\textsuperscript{141}

With respect to the protection of non-investors, the team production theory of bankruptcy reorganization asserts that it justifies “bankruptcy’s service of a broad range of interests.”"\textsuperscript{142} The team production theory of bankruptcy reorganization criticizes the fact that the creditors’ bargain theory, by “concluding that bankruptcy exists solely for the benefit of creditors and shareholders”, provides a statement of the objectives of bankruptcy reorganization, which is positively and normatively too narrow."\textsuperscript{143}

However, it should be noted that the team production theory of bankruptcy reorganization is only a theory explaining the bankruptcy reorganization of public corporations and is not a theory concerning the whole bankruptcy law. Moreover, the proponent pointed out that “Team Production is not a theory with which I feel comfortable.”"\textsuperscript{144} “The theory is based on a wholesale grant of unfettered power to directors. My inclination is to think that will not work. Power corrupts, and absolute power corrupts absolutely.”"\textsuperscript{145} “Researchers can test the Team Production Theory empirically by determining whether the actual contracts match those asserted by the Team Production theorist.”"\textsuperscript{146}

\section*{2.1.6 \textbf{Comparison and Choice}}

After comparing the representative theories concerning bankruptcy law, the author adopts the creditors’ bargain theory as the theoretical device for analyzing the bankruptcy reorganization law of the chosen countries in this book. The reasons for choosing the creditors’ bargain theory are discussed below.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{140} Id, pp. 766-7.
\item \textsuperscript{141} Id, p. 767.
\item \textsuperscript{142} Id, p. 766.
\item \textsuperscript{143} Id.
\item \textsuperscript{144} Id, p. 778.
\item \textsuperscript{145} Id.
\item \textsuperscript{146} Id, p. 744
\end{itemize}
\end{footnotesize}
2.1.6.1 The Decisive Role of the Economic Value among All the Values of a Corporation

Irrespective of any one of these theories, either outside or inside bankruptcy, the economic value is the most decisive among all the values of a corporation. A corporation comes into existence with the ultimate goal of making a profit. To put it differently, market investors invest in a corporation, as shareholders or as creditors, with the goal of making a profit. While pursuing the economic value, a corporation brings benefits to the society, such as increasing employment opportunities, enhancing community wealth and bringing convenience to the community residents’ life etc., and thus obtains moral, political and social values. Therefore, the basic logic in the operation of a corporation is that its economic value is the basis for all other non-economic values, or that its non-economic values are the byproducts or the derivatives of its profit-making activity.

When the corporation is trapped in difficulty, enters into the bankruptcy procedure in order to find a solution to the difficulty, the relationship between the economic value and the other values should not be overturned. If outside bankruptcy, a debtor is a corporation for making a profit, it should not be changed into a philanthropic organization with the protection of some non-economic values as the ultimate goal simply because it is in financial distress and has entered into the bankruptcy proceeding. Bankruptcy law should not force the investors of a corporation to change their ultimate goal of profit-making to social-value-protection upon entering the bankruptcy procedure. Since the investors are allowed by non-bankruptcy law to set up a corporation with the ultimate goal of making a profit, they should be allowed to keep the same ultimate goal when they need to solve the corporation’s financial problems in the bankruptcy proceeding. Therefore, the non-economic values should not triumph over the economic value even if a corporation has entered into bankruptcy proceeding. Inside bankruptcy, the non-economic values, as derivatives of the economic value, can only be achieved on the basis of the economic value.\(^{(147)}\) It has been commented that a business

---

\(^{(147)}\) Corporations may be categorized into not-for-profit corporations and for-profit corporations/business corporations. Not-for-profit corporations are often public corporations that are created by government to carry out some public functions. Stephen M. Bainbridge (2002), Corporation Law and Economics, Foundation Press, p. 2. A not-for-profit corporation comes into existence for carrying out certain public functions and protecting some non-economic values. The difference between a not-for-profit corporation and a for-profit corporation is that the government shareholder of a
corporation’s social values, such as its contribution to employment or community welfare, cannot be realized unless its income exceeds the costs of production. The fundamental flaw of the bankruptcy-policy theory, value-based theory, and risk-sharing theory is that these theories, by vindicating that bankruptcy law may allow non-economic values to triumph over the economic value, fail to recognize the decisive power of the economic value among all the values of a corporation.

2.1.6.2 The Problem in Taking the Protection of Non-investors as One Goal of Bankruptcy Law

Compared with the creditors’ bargain theory, the other theories define the goal of bankruptcy law in a more ambitious and broader way, since the other three theories, to different extents, hold that bankruptcy law should help to mitigate the negative social effects caused by business failure and protect the interests of all the parties affected by the business failure. According to the other theories, in order to achieve the function of solving the social problems caused by business failure, bankruptcy law may contain wealth redistribution provisions and provisions on the protection of non-investors. Since the provisions on wealth redistribution among the investors are analyzed in the Section 2.1.6.3, this section discusses the protection of non-investors in bankruptcy law.

First, it is problematic to force the investors to bear the cost for protecting the values held by non-investors, whom happen to be affected by the business failure and with whom they do not

---

not-for-profit corporation need not pursue economic value. However, the other investors, such as shareholders and creditors, invest in it for making economic profit. In its operation, a not-for-profit corporation, just like a for-profit corporation, should pay its debt according to the contract and non-bankruptcy laws. Where a not-for-profit corporation is in financial distress and enters into bankruptcy to solve its financial problem, just as outside bankruptcy, its market investors should not be forced to bear the costs for its social function and non-economic value. If the government wants to rescue it to protect social values, the government should bear the costs for protecting such social values. By using the bankruptcy law designed for for-profit corporations, the market investors of a not-for-profit corporation are protected in the same way as those investors of a for-profit corporation since bankruptcy law is designed to ensure the maximization of the debtor’s overall economic value and the maximization of the market investors’ recovery. For the convenience of analysis, this book is confined to the analysis of the bankruptcy of for-profit corporations/business corporations.


The risk-sharing theory does not directly state that a corporation’s non-economic values could triumph over its economic values. However, by proposing that bankruptcy law should protect the shareholders’ non-pecuniary or sentimental investment and non-investors, it actually implies this idea. See 2.1.4.2 for discussions concerning the protection of non-economic values by the risk-sharing theorists.
have a direct legal relationship. If bankruptcy law forces the investors of a corporation to abandon the goal of maximizing the debtor’s economic value for the sake of other kinds of values, bankruptcy law actually forces the investors to pay for the benefits of non-investors. Under this circumstance, wealth redistribution is created, which may cause the problem of forum shopping between bankruptcy and non-bankruptcy proceedings.\(^\text{150}\) The risk-sharing theory argued that if the benefits of wealth redistribution exceed the cost of forum shopping, wealth redistribution can be accepted and that making this judgment needs empirical study.\(^\text{151}\) But it is not easy to conduct an empirical study that provides an exact calculation of the benefits and cost of a wealth redistribution provision. Some normative analysis of both sides may provide certain help. As discussed in the two paragraphs below, detailed examination of the benefits caused by bankruptcy law’s protection of non-investors reveals that the benefits are illusory because it is difficult to define the value held by non-investors that should be protected by bankruptcy law and that bankruptcy law does not seem to be the proper way for protecting non-investors’ interests.

It is problematic to use the bankruptcy law to provide protection to the non-investors affected by the business failure, because it is difficult to define the value held by non-investors that should be protected by bankruptcy law. For instance, it is difficult to define the value of the interest held by the community. It is unclear which kind of community interest should be protected. If we allow market competition, we must accept the changes in our life caused by the death of certain corporations, which releases capital and manpower that might build the basis for the birth of new corporations. Frost noticed that “[w]hile liquidation may harm the community served by the closed enterprise, it may benefit a distant community served by a competing enterprise.”\(^\text{152}\) When the values held by non-investors are ambiguous, it is problematic to use the bankruptcy law to provide appropriate protection to these ambiguous values.

Bankruptcy law does not seem to be the best way for protecting the interests or values held by

\(^{150}\) Please refer to Section 2.1.1.2 for the forum shopping problem.
non-investors affected by business failure. Frost concluded that “the bankruptcy process is institutionally incapable of achieving redistributive goals.”¹⁵³ Baird commented that if some values need to be protected, it is better to provide a clear protection system within the context of the whole legal system instead of within the bankruptcy law.¹⁵⁴ Wealth redistribution provisions in bankruptcy law can only provide limited protection to victims of cases that enter into bankruptcy proceeding. Even if a corporation does not enter into bankruptcy, it may dispel workers, change its business from one kind into another, move from one community to another, or dissipate without going into the formal bankruptcy proceeding. All these business activities, just like bankruptcy, can negatively affect some persons and communities. However, the victims in these cases cannot receive equal protection since these situations are outside of the application scope of the bankruptcy law.¹⁵⁵ Therefore, when we attempt to protect the non-investors in bankruptcy law, we need to think whether we could recognize this value and provide complete and consistent protection within the whole legal system, whether the coherency between bankruptcy law and non-bankruptcy law is preserved and the problem of forum shopping may be avoided. For instance, with respect to the protection of the employment opportunity of the affected workers, compared with forcing the investors of a debtor corporation in a bankruptcy case to provide unpredictable and inconsistent protection through wealth redistribution provisions in bankruptcy law, a social security system concerning protection of all the unemployed workers seems to be a more reasonable way.¹⁵⁶

To summarize, while it is ideal to protect all the values held by the parties affected by the business failure, it seems to be sub-optimal to use bankruptcy law to provide protection to the non-investors influenced by business failure.

¹⁵³ Id, p. 75.
¹⁵⁴ “Legal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them.” Douglas G. Baird (1987), Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815, p. 822. “Other things being equal, one would want to transplant what good things are done in bankruptcy to ordinary avenues of rights enforcement and do away with bankruptcy law.” Id, p. 824.
¹⁵⁶ Id, pp. 828-31.
2.1.6.3 The Creditors’ Bargain Theory and the Wealth Redistribution Rules in the Real Bankruptcy Law

The competing theories of the creditors’ bargain theory commonly point out that the wealth redistribution provisions contained in the real bankruptcy law prove the failure of the explanatory power of the creditors’ bargain theory. However, the existence of wealth redistribution provisions in the real bankruptcy law is not sufficient to fundamentally overthrow the explaining power of the creditors’ bargain theory. First, the fact that the real bankruptcy law contains wealth redistribution provisions cannot by itself prove the failure of creditors’ bargain theory. Baird pointed out “one can not derive the normative from the positive.” What the bankruptcy law is can not prove the creditors’ bargain theory completely wrong, since the creditors’ bargain theory is to provide a normative theory of what bankruptcy law should be. On the contrary, we need to check whether the real law is based on a normative theory that is better than the creditors’ bargain theory, if it is not, then how should the law be improved according to the creditors’ bargain theory.

Second, most of the wealth redistribution provisions in the real bankruptcy law can be explained by the creditors’ bargain theory. After careful examination, one may find that most of the redistribution provisions in bankruptcy law are caused by the collectivization of the disparate debt collection activities, serve the goal of minimizing the debt-collection costs and maximizing the debtor’s overall value, and thus are consistent with the creditors’ bargain theory. The redistribution provisions can be divided into four categories: (1) redistribution provisions that enhance the overall value by avoiding a race of debt-collection and minimizing debt collection costs and risks (for instance, provisions concerning equal distribution to similarly situated creditors or pro rata payment to general unsecured creditors); (2) redistribution provisions that preserve and enhance the overall value by preventing harmful strategic behaviors (for instance, provisions on preference avoidance); (3) redistribution provisions that preserve the debtor’s going-concern value and maximize the debtor’s overall value (for instance, providing the DIP or the bankruptcy trustee the power of

deciding whether to continue or abrogate the executory contracts, automatic stay of the
secured creditors’ right, the opportunity of rehabilitation); (4) redistribution provisions that
enhance the protection of some specific parties (for instance, providing enhanced priority to
employees and taxing authorities). The first three kinds of redistribution are caused by the
collectivization of debt-collection activities, and are the devices for minimizing collection
costs and maximizing the overall value, and thus can be explained by the creditors’ bargain
theory. The first three kinds of redistribution provisions may damage the pre-bankruptcy
entitlements of some parties, such as secured creditors, or creditors who hold preferred claims.
According to the creditors’ bargain theory, the damage is justified if the damage is less than
the corresponding benefits.

The problem with the creditors’ bargain theory is that it does not provide a justification for the
existence of the fourth kind of redistribution provisions, i.e. the enhanced priority of some
special unsecured claims. However, we need to examine whether this kind of wealth
redistribution provisions is really necessary. Take the enhanced priority of employees’ claims
and tax claims as an example. Should the protection of employee claims and tax claims be
achieved only within formal bankruptcy proceedings or should these be achieved both inside
and outside bankruptcy proceeding? The proponents of the creditors’ bargain theory have
argued that if the protection of employee’s claims and tax claims is a legislative policy, it is
more reasonable to implement it within the context of the whole legal system instead of
implementing it through wealth redistribution provisions within bankruptcy law.\textsuperscript{158} For
instance, in order to provide special protection to employees’ claims, labor law may provide
that where the debtor defaults on more than one of its payment obligations, the employees’
claims should be paid before other unsecured claims. Default is not necessarily related to
bankruptcy.\textsuperscript{159} Where a corporation is pursued by several creditors or dissipates value without
entering into the formal bankruptcy proceedings, the protection of employees’ claims and tax
claims is problematic if one needs to only rely on the wealth redistribution provisions in
bankruptcy law to provide protection.

Indeed, after carefully reading China’s bankruptcy and non-bankruptcy law concerning the

\textsuperscript{158} Douglas G. Baird (1987), Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren,
\textsuperscript{159} Id, p. 829.
protection of employees’ claims and tax claims, the author finds that the legislators intend to provide equal protection inside and outside bankruptcy when the debtor defaults on several obligations. For instance, Article 45 of the Law of the People’s Republic of China on the Administration of Tax Collection (“LOATC”)\(^{160}\) provides: “when the taxing authorities collect tax, their tax claims should be superior to other unsecured claims, unless other laws provide otherwise. If the tax occurred before the establishment of mortgage, pledge, or lien on the tax payer’s assets, the tax claim should be paid before the execution of the mortgage, pledge, or lien.” Obviously, Article 45 of LOATC intends to ensure the protection of tax claims outside bankruptcy proceedings. Another example is Article 187 and 188 of the Company Law of the People’s Republic of China (“CL”).\(^{161}\) Article 187 of CL provides that where the debtor dissolves, the debtor’s assets should be liquidated and the proceeds should first be used to pay all the unpaid claims. After paying all the claims, the remaining property shall be distributed to its shareholders. Article 188 of CL further provides that where the debtor’s assets are not enough to pay all the creditors, the company shall apply to the court for bankruptcy. Article 188 of Chinese company law reflects that, since bankruptcy law has come into existence and provided the priority order for all the claims in a uniform way, non-bankruptcy law has become reliant on bankruptcy law and simply refers to bankruptcy law for the priority order instead of providing the priority order directly. Article 45 of LOATC, Article 187 and 188 of CL reflect that the priority order of the Chinese bankruptcy law,\(^{162}\) although providing enhanced priority to employees’ claims and tax claims, is not a form of wealth redistribution, but simply a reflection of the priority order under the non-bankruptcy law. To summarize, a comprehensive reading of the distribution provisions in LOATC, CL and EBL supports the idea of the creditors’ bargain theory that the priority order in bankruptcy law should be a centralized and clear reflection of the priority order established under the non-bankruptcy law instead of being a new kind of priority order meant to be different to that under the non-bankruptcy law.

\(^{160}\) Passed by the Standing Committee of the Seventh People’s Congress on February 28, 1992; modified on April 28, 2001 and the modified version became effective on May 1, 2001.


\(^{162}\) The EBL, Art. 113.
Therefore, even if the real bankruptcy law contains the fourth kind of wealth redistribution provisions, this phenomenon cannot overthrow the explanatory power of the creditors’ bargain theory. It is suggested here that legislative reform should be conducted according to the creditors’ bargain theory to remove the fourth kind of wealth redistribution. When the priority order under bankruptcy law is different from that under non-bankruptcy law, we should first check which priority order is meant to be the correct reflection of the legislative policy and then modify the relevant provisions to ensure that the bankruptcy priority order is just a reflection of the non-bankruptcy priority order and that there is only one uniform priority order concerning debt payment inside and outside bankruptcy.

2.1.6.4 Conclusion

Based on the preceding discussions, the author considers that the creditors’ bargain theory defines the function of the bankruptcy law in a reasonable and practical way while the other theories impose an ambitious function on bankruptcy law. The creditors’ bargain theory, because of its merits in providing a convincing normative analysis on the goal of bankruptcy law, the relationship between bankruptcy and non-bankruptcy law, and the major provisions and systems of bankruptcy law, has been widely adopted as the normative bankruptcy theory for judging and analyzing the detailed bankruptcy provisions and systems.163 Therefore, the creditors’ bargain theory is adopted in this book as the theoretical device for examining the efficiency of the detailed provisions and sub-systems of the bankruptcy reorganization law of the chosen countries in this book.

---