1-1-2008

"Control" in Reorganization Law and Practice in China and the United States: An Essay on the Study of Contrast

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Recommended Citation
22 Temp. Int'l. Comp. L.J. 141
Studying the law of other legal systems is becoming increasingly important in a globalized world, but it is not an easy task. Every legal system is embedded with and reflects the culture and history of the place where it operates. Even foreigners who possess a command of the country's language will face difficulties in attaining a deep understanding of that country's legal system because of the social and cultural context within which it exists. The more distant the history and traditions of the foreign country, the more impenetrable the legal system will be to outsiders and the more complicated a study of the legal system will be.

The Chinese legal system and, in particular, its new law governing bankruptcy, is no exception. While there is an acceptable English translation of the law, the language often does not map well. Moreover, the Chinese bankruptcy law exists within a legal tradition that can only be described as alien to that of the United States.¹

During the fall of 2007, I had the unique opportunity to teach the U.S. law of business reorganizations in China, a mere three months after China's new bankruptcy law came into effect. The course was in English and delivered to a group of very talented Chinese lawyers in an LL.M. program. The program is part of a collaboration between Temple University in Philadelphia and Tsinghua University in Beijing. While I was incapable of teaching the Chinese law, it was inescapably relevant to our study of the U.S. system, if only in its sharp contrasts to the U.S. law. But even a casual focus on the Chinese provisions themselves delivered yet another benefit of comparative law study—it offered insights into the U.S. system that would be far more difficult to come by otherwise.

¹ Simple examples can suffice. China's highest court has over 300 judges, while the United States Supreme Court has only nine. Furthermore, China follows an inquisitorial trial system, while the U.S. system can be described as finding truth through battle. China's Constitution might be better viewed as a planning document than a set of constraints applicable to all those who wield power. See generally DANIEL C.K. CHOW, THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA IN A NUTSHELL (West Group 2003).
The most glaring difference between the two bankruptcy regimes was the U.S. system's different way of treating business debtors in reorganization cases. Those differences, and their policy implications, are important for both the U.S. and the Chinese systems. It appears worthwhile to outline briefly those aspects of the American system that seem so different because they might offer insights to Chinese lawyers about their own system and demonstrate to American lawyers that those features we may take for granted are anything but self-evident. Such an exploration can also uncover important differences between the "law on the books" and the "law in action." These differences further demonstrate the critical importance of context in understanding the operation of the law and the corresponding hazards that comparative study presents to those from other legal systems.

Part 2 of this Comment begins with a brief outline of some broad differences between the two systems, insofar as they concern the business debtor's control over the reorganization and related power vis a vis its creditors. As we will see, this power in theory and in practice might be radically different and, in the United States, appears to have changed over time. Understanding that there may be divergence between a statute's text (and perhaps its intent) and its actual operation is central to recognizing the critical importance of context in both business and comparative law. Part 3 will briefly consider the historic and ideological sources for what might be called the U.S. approach, its weaknesses, and its implications for addressing the problems of financially distressed businesses.

II. COMPARING THE U.S. AND CHINESE BANKRUPTCY LAW

At the outset, one would expect Chinese bankruptcy law to be very different from the law in the United States. China's bankruptcy law was drafted against a wholly separate set of economic and legal assumptions. For example, China's law was drafted for an economy that still includes many State Owned Enterprises (SOEs) on whom employees are far more dependent than employees in the United States and whose economic demise can mean a greater disaster for those dependent on them. In such an environment, one expects the State to have a greater interest in involving itself in the financial problems of its businesses. At a basic level, China's underlying theory of the State and its relationship to its citizens, the relationships of its citizens to one another, and the legal system that emerges from a collectivist, rather than individualistic set of assumptions, inevitably informs and sharpens one's understanding of the workings of Chinese law. As a result, an outsider not immersed in Chinese culture will have great difficulty understanding the new law, if it is even possible to do so.

Context is central to understanding the American bankruptcy system as well. The United States has had a near-religious faith in the free market that grew during the 1970s and 1980s. The United States may be the only modern industrialized country without strong job security for working men and women.2 It has a very weak social safety net. The individualist nature of U.S. culture creates a legal

context that demands that most citizens fend for themselves. There is a deep suspicion of government involvement in economic matters that probably grew with the new faith in the free market.\footnote{The United States litigation system mirrors the free market system, with litigants battling it out before passive, neutral judges.}

The 1978 United States Bankruptcy Reform Act ("the Code") was a wholesale revision of the 1898 Bankruptcy Act that had, itself, been deeply revised in the 1930s during the Great Depression.\footnote{See generally RONALD TROST ET AL., RESOURCE MATERIALS: THE NEW FEDERAL BANKRUPTCY CODE 251 (1979) [hereinafter RESOURCE MATERIALS].} Efforts to revise the U.S. law began in 1970, at the same time that consumer and environmental law became increasingly recognized in Congress and the courts,\footnote{See generally RALPH NADER, UNSAFE AT ANY SPEED: THE DESIGNED-IN DANGERS OF THE AMERICAN AUTOMOBILE (1965) (discussing the need for better consumer protection for automobiles); RACHEL CARLSON, SILENT SPRING (1962) (discussing need for environmental protection measures for the dangers of pesticides and petrochemicals).} and at the very beginning of the counterpoint movement known as "Law and Economics."\footnote{See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (1972); Arthur Alan Leff, Economic Analysis of Law: Some Realism About Nominalism, 60 VA. L. REV. 451 (1974).} While U.S. bankruptcy law was changed in minor ways several times after 1978, and substantially revised in 1984 and 2005, none of the post-1978 revisions to the text addressed in a fundamental way the relationship between the business debtor and its creditors, and the debtor and the reorganization process itself.\footnote{See generally RESOURCE MATERIALS, supra note 4, at 251.}

The following sections describe the Code structure as designed in the legislation. This structure is the default setting for situations where the debtor and creditors do not agree in advance to alter the rules or time periods. The empirical data suggest substantial deviation from the original design, particularly in accelerating the process through various arrangements among the debtor, creditors, and lenders. These and similar developments have implications for the "law in action" and suggest that practice deviates from the law on the books. We will return to these developments later in the discussion.

A. Control of Legal Status: Statutory Framework

1. Filing is Bankruptcy

An American reorganization case formally begins when the debtor or a creditor files a bankruptcy petition.\footnote{11 U.S.C. § 301 (2000).} It is arguably the same in the Chinese
but even at this threshold level, the two systems have profound
differences.

In the United States, a voluntary filing is the “order for relief in a voluntary
case.” This is something we take for granted in the United States, and it means
that the debtor can alter its legal status vis a vis its creditors by an act of its own
will. Having near complete control of the timing, the debtor can either use, or
threaten to use, the voluntary filing strategically. Much like its American
counterpart, Chinese law requires the debtor’s application to contain many
specifics. Significantly, however, in China’s bankruptcy law, the debtor “applies”
for bankruptcy, and the law contemplates an “acceptance” of the bankruptcy
petition in every case. Such acceptance generally occurs within fifteen days of
receipt of the application.

The implication of this seemingly minor difference is both fundamental and
striking. Unlike its American counterpart, the Chinese court need not “accept” the
application, and, given this, one can imagine that at least some creditors will
attempt to persuade the court to keep debtors out of bankruptcy altogether. In
China, to achieve the change in legal status, the debtor must meet a burden of
proof as a prerequisite to its change of legal status. In the United States, the status
of bankruptcy in voluntary cases is almost entirely within the debtor’s control.

2. Insolvency is Not Required

It often comes as a surprise to students of U.S. bankruptcy law that no form of
insolvency is required before a business debtor can enter bankruptcy through a
voluntary petition. Put differently, a business in excellent financial health can

provides that “[w]here the debtor fails to pay off its due debts, it may file an application
with the people’s court for revival or bankrupt liquidation.” (emphasis added). Law on Enterprise
Bankruptcy (P.R.C.), art. 7 (promulgated by the Standing Comm. Nat’l People’s Cong., Aug. 27,
2006, effective June 1, 2007) [hereinafter Chinese Bankruptcy Code].

this title constitutes an order for relief under such chapter.”).

11. The literature makes it clear that, while the debtor may have legal control over the
decision to file, others can come close to controlling that decision through their leverage. See,
e.g., David A. Skeel, Jr., Creditors’ Ball: The “New” New Corporate Governance in Chapter 11,

12. Most of the specifics required under American bankruptcy law are specified in the local
rules and (effectively) in sample forms.

13. Chinese Bankruptcy Code, supra note 9, art. 8.

14. Id. art. 10.

15. Id. art. 10.

16. There are limits in the United States. For example, one cannot file a bankruptcy petition
in “bad faith,” and a voluntary filing is open to such a challenge. See In re SGL Carbon
Corporation, 200 F. 3d 154 (3d Cir. 1999). However, successful challenges are rare. See
ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS
430 (5th Ed. 2006). Perhaps as important is the fact that there are challenges that require
creditors to take the initiative and sustain their argument to the satisfaction of the court.

17. RESOURCE MATERIALS, supra note 4, at 251.
begin an American bankruptcy proceeding.\textsuperscript{18} This has led both to abuse\textsuperscript{19} and to innovative uses of bankruptcy, such as Johns Manville’s application of the bankruptcy process to address its pervasive products liability problem in the 1980s.\textsuperscript{20} Perhaps equally important is the absence of threshold criteria, which further vests the decision regarding bankruptcy status solely in the hands of the debtor. This eliminates the front-end complexity of proving (or defending) a “need” for bankruptcy.

Conversely, China’s law requires an “acceptance” of the bankruptcy application in a voluntary case and, presumably, an adjudication that the debtor is properly within the bankruptcy system. The general criteria, familiar to those in the field, are roughly equitable insolvency (generally not paying debts as they become due)\textsuperscript{21} and bankruptcy insolvency.\textsuperscript{22} Apparently, some evidence that the debtor meets the criteria will be required. This will entail at least some expense and delay and, of course, a debtor will never be certain that its application will result in “acceptance.” Thus, a company’s ability to threaten a bankruptcy filing or to use voluntary bankruptcy in a strategic way is vastly inferior to that of a debtor with access to U.S. bankruptcy law.

3. Debtor Leverage Implications

The implications of these major differences are significant. One immediate consequence of the U.S. debtor’s power is direct initial control over imposing the automatic stay. The moment a debtor files his or her petition, an automatic stay, purporting to be effective all over the world,\textsuperscript{24} arises by operation of law.\textsuperscript{25} This allows the debtor to stop a pursuing creditor dead in its tracks\textsuperscript{25} and converts the expense the creditor has sustained in chasing the debtor into a wasted expense. As

\begin{itemize}
  \item \textsuperscript{18} All filings are subject to a challenge on the basis of bad faith. See \textit{In re SGL}, 200 F.3d at 160-62.
  \item \textsuperscript{19} See id.
  \item \textsuperscript{21} Chinese Bankruptcy Code, supra note 9, art. 2 (expressing “[w]here an enterprise legal person fails to clear off its debts as due . . . or if it is obviously incapable of clearing off its debts.”)
  \item \textsuperscript{22} Chinese Bankruptcy Code, supra note 9, art. 2 (including the language “and if its assets are not enough to pay off all the debts.”).
  \item \textsuperscript{23} 11 U.S.C. § 541(a)(1); See also \textit{WARREN & WESTBROOK}, supra note 16, at 837.
  \item \textsuperscript{24} 11 U.S.C. § 362.
  \item \textsuperscript{25} The author recently observed a hearing involving a bankruptcy filing that occurred at 9:57 a.m. which, if effective (validity of the filing was the question at issue), would have voided the Sheriff’s Sale that occurred three minutes later, whether or not the Sheriff’s office had notice. Once the creditor is on notice of the bankruptcy case (the debtor’s lawyer will ensure that notice gets to creditors), further pursuit of the debtor can result in sanctions for contempt of court and damages for the debtor. See \textit{Nissan Motor Acceptance Corp. v. Baker}, 239 B.R. 484 (N.D. Tex. 1999).
\end{itemize}
one would expect from the logic of the Chinese system, China’s analog to the automatic stay does not arise until the court accepts the application.26

In addition, in U.S. bankruptcy law, the act of filing the petition creates a bankruptcy estate consisting of all of the debtor’s property, which is broadly defined.27 The automatic stay also enjoins creditors from disturbing that property.28 Again, China’s law produces a similar result only from the time the court accepts the application.29

In the United States, the debtor’s unilateral and largely unfettered ability to alter its legal status, and confer onto itself powers that it lacks outside of bankruptcy,30 is leverage that operates independently of the actual bankruptcy filing. By filing a bankruptcy petition, the debtor acquires the power to avoid various pre-petition transfers, including seizures of the debtor’s property and payments extracted by threat of legal seizure.31 The debtor’s exercise of these powers converts a creditor’s sunk costs on collection efforts into wasted expenses. Whether consciously or unconsciously, the U.S. formulation seems designed to generate negotiations between debtors and creditors. This negotiation would be far less likely if the debtor did not have almost complete legal control over its decision to enter bankruptcy.

Knowledgeable players know these basics and will consider them when deciding how best to collect their debts. Most creditor seizures will be preceded by some communications with the debtor, if only dunning letters32. Seizing property costs money, some of which may not be recoverable. Moreover, a creditor can generally net a better return if the debtor can be convinced to pay voluntarily. The content of these negotiations will be far richer because the debtor has the power to shift the tables by filing a bankruptcy petition.33

Because the debtor can always make a realistic threat of voluntary bankruptcy, the creditor’s eventual Chapter 7 distribution (whatever its projected value) becomes a reference point almost as important as the face value of the debt for that negotiation. One can see the enhanced potential for compromise because bankruptcy law injects a counterweight into the negotiation that would be absent

26. See, e.g., Chinese Bankruptcy Code, supra note 9, arts. 16, 20.
29. See Chinese Bankruptcy Code, supra note 9, arts. 17, 18.
30. Section 1107 gives the debtor in possession all the powers of the trustee in bankruptcy. See infra pp. 106-07.
31. The Code gives the trustee (here the debtor in possession) the right to avoid various prepetition transfers including liens, BRA § 544, statutory liens, BRA § 545, and preferences, BRA § 547.
33. Absent bankruptcy, US state law allows creditors to seize debtor property (using appropriate judicial procedures) and gives the debtor few options to avoid seizure other than full payment. In such a rigid legal environment, there would not be much for the debtor and creditor to discuss. However, once we add to the discussion the debtor’s realistic threat of bankruptcy, with all its implications, the balance changes significantly.
otherwise. The Chinese system offers no comparable negotiating tool to the debtor, at least on the face of it.34

B. Control within the Reorganization: Statutory Framework

Like the former Chapter X of the U.S. Bankruptcy Act,35 a Chinese business bankruptcy has, at its center, a bankruptcy administrator to whom the law entrusts most of the decisions that will affect the future direction of the business.36 U.S. bankruptcy law departed from that model in the 1978 Bankruptcy Code by giving the “debtor in possession” (“DIP”) the powers of the bankruptcy trustee in nearly all cases.37 Moreover, under the Code, the DIP is permitted to run the business and enter into “ordinary course” transactions as it sees fit.38

Substituting the DIP for the trustee saves money for the estate. A trustee would nearly always be an add-on expense, or at least until the ranks of management were trimmed. Moreover, for all but the simplest businesses, one imagines a substantial learning curve for a new manager that would produce an interruption of the normal routine of the business.39 The pertinent question is whether the savings provoked by avoiding a trustee will offset the substantial problems that accompany this arrangement.40

It seems counterintuitive to entrust with management in the bankruptcy case the very team that brought the firm into bankruptcy. Critics of the statutory scheme argue that this is the team that was instrumental in bringing on financial woes, and to allow them to continue, and to continue with an enhanced set of legal tools no less, is to force creditors to throw good money after bad.41 Those who defend the statutory scheme argue that not all financial distress is the result of bad management decisions.42 In those cases where outside forces have played a major role, positive harm would result to creditors from replacing the debtor’s

34. Whether, owing to different cultural practices, Chinese debtors and creditors negotiate more (or less) than their American counterparts when the debtor encounters financial distress is unknown. It seems clear, however, that the American system has facilitated or encouraged negotiation by altering a playing field that would, in the absence of a debtor-controlled bankruptcy process, be very unbalanced.


37. See RESOURCE MATERIALS, supra note 4, at 265-69. It is possible to have a trustee appointed if someone makes the appropriate motion but the occasions for this are rare. See In re SGL Carbon Corp., 200 F. 3d 1154 (3d Cir. 1999).

38. 11 U.S.C. § 363(c)(1).


41. LoPucki, supra note 40 at 263.

42. See [resource materials . . .]
management team. U.S. law seems partly to reflect a view that the negative effects of retaining even bad management are offset by both the speed and saved expense of leaving the debtor’s management in place.

There is also a practical problem with debtor control. The DIP is a different legal entity than the debtor that preceded it. The trustee, in whose shoes the DIP stands, is a fiduciary for the debtor’s creditors. Is it possible for the DIP, who may have had an antagonistic relationship with many creditors before the filing, to selflessly act in their best interests after the filing? Not doing so, at least in an obvious way, can be grounds for the appointment of a trustee. But between these extreme cases and the fiduciary ideal, slippage, perhaps even extreme slippage, was easily foreseeable to those who designed the Code.

C. Control Over the Reorganization Plan: Statutory Framework

The Bankruptcy Code gives the Debtor an “exclusivity period” to file a Plan of Reorganization. During that period, the debtor runs the business, and attempts to reshape its future through development of a business plan. The Reorganization Plan will emerge from this business planning. Other parties to the reorganization have no legal access to the business planning of the debtor, and the DIP often does not present its Reorganization Plan until the end of the one hundred twenty day period. After that, the DIP has another sixty days while creditors react to it.

Allowing the DIP this planning period could, in unfortunate cases, simply hold creditors at bay for an additional six months while the Debtor slides further downhill. Both businesses that are potentially viable and those that are hopeless have this ability under the Code to effectively postpone the day of reckoning. Moreover, the Code provides no mechanism an independent assessment of a business’s viability. Management, of course, has many personal economic incentives to remain optimistic.

D. Venue

China’s law places venue where the debtor is domiciled, apparently supplying little or no choice about where to file the bankruptcy case. The law in the United States is very different in that it permits a considerable amount of choice about

43. 11 U.S.C. §§ 738, 742
44. In re Wilde Horse Enter., Inc., 136 B.R. 830 (Bankr. C.D. Cal. 1991)
46. 11 U.S.C. § 1121(c)(3).
48. Id. at 693.
49. 11 U.S.C § 1121(c)(3).
50. LoPucki, supra note 40, at 258-261.
52. See generally Chinese Bankruptcy Code, supra note 9.
where an enterprise may file its Chapter 11 case. Among other places, the case could be filed where the debtor has its principal place of business, where its assets have been located for the one hundred eighty days prior to the filing, or where it is domiciled. U.S. cases have held that domicile includes the place where the corporation is incorporated. Combined with the statutory control the U.S. debtor has over when to file, as well as over the estate once the case is filed, this difference makes the two systems stand in stark contrast. “Venue shopping” is possible in the United States in a way that it is not in China.

In the business bankruptcy area, venue shopping in the United States has become a focus of heated debate. In the United States’ largely voluntary business bankruptcy system, it is clear from the empirical data that those who control the corporate debtor are choosing where to file for strategic reasons. The debate concerns why they are doing so and whether this is a good thing. With venue largely fixed by law in China, this is a debate that would be unlikely to arise there.

E. Summary of Significant Statutory Control Issues

The U.S. business debtor can exercise almost complete legal control over its own legal status by simply filing a bankruptcy petition. The debtor has at least some choices about where to file a bankruptcy petition, and the evidence shows that debtors use that choice strategically. Once within the protection of the bankruptcy system, the U.S. debtor typically retains legal control over the business and the process of formulating a plan of reorganization. The debtor also has the powers and responsibilities of a trustee in bankruptcy, which is to say, it acquires bankruptcy powers that debtors outside the bankruptcy process do not enjoy.

In these respects, China’s statutory system could scarcely be more different from the U.S. statutory system. There, in a voluntary case, the debtor applies for bankruptcy protection and its application may or may not be accepted. The place where the application should be filed is fixed, at least relative to the United States.
system. Once in bankruptcy, the debtor will surrender control of the business to an administrator. If other entities will wrest that control from the debtor, it will be with the debtor’s consent, through contractual arrangements of one sort or another. Scholars in the United States have developed extremely rich data in an effort to understand the real workings of the business bankruptcy system. But even with the data, the real workings of the system remain opaque.

We can see divergence of statutory design and practice in the studies that preceded the Code itself. Congress changed the statute from one dominated by

F. Real Control

Understanding the statutory design and the cultural context that contains the design is a threshold requirement to understanding a bankruptcy system. This alone presents substantial challenges to the comparativist, but there is much more. The law of business reorganization does not exist in a vacuum; it exists within a larger economic and legal environment where the players learn to use the law to their best advantage. As they do so, business practice evolves around and through the statutory constraints so that, over time, the practice the legislature expected or intended and the actual practice that emerges can diverge. Because the statutory design and the emerged practice may be divergent, looking at a reorganization system without taking into account the developed practice may give a misleading or incomplete picture. A policymaker considering the U.S. system as a possible model would want to understand both its statutory structure and its actual workings. We can see an example of divergence of the two in the U.S. system by focusing again on “control.”

Simply moving our focus from “statutory control” to “real control” muddies the picture considerably. What is control? Does a debtor with legal control really have control if someone else with leverage is dictating the debtor’s moves? Further, assuming one can adequately define “control,” how does one learn whether one entity or another has it? Moreover, “real control” may not be the same in all cases. For example, large corporations with boards of directors that are not controlled by management may experience very different pressures than small businesses, where ownership and management are the same. In all cases, the Code’s design places “statutory control” largely with the debtor. If other entities will wrest that control from the debtor, it will be with the debtor’s consent, through contractual arrangements of one sort or another. Scholars in the United States have developed extremely rich data in an effort to understand the real workings of the business bankruptcy system. But even with the data, the real workings of the system remain opaque.

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57. Id.

58. While the Code vests a great deal of legal control in the debtor, it is probably rare that the debtor is autonomous. Rather, the debtor is influenced by myriad pressures and may, in fact, be controlled by others despite the law’s structure.

59. Professors Lynn LoPucki and William Whitford, among others, have developed rich data from which they have drawn numerous conclusions about the actual control issues within business bankruptcy. See, e.g., [CITES TO THE LOPUCKI/LOPUCKI-WHITFORD PIECES IN THIS ARTICLE.
creditor control to one of more debtor control because it found that creditors were not exercising the control they had, reporting that “[c]reditor control in bankruptcy is a myth.”

This was recognition that practice had evolved from what was intended into something different, and drove a conclusion that this difference required statutory correction. The statutory correction moved a great deal more control to the debtor. Part of the rationale was to encourage early filing and more successful rehabilitations by reducing disincentives to management’s filing decisions.

If history were any guide, one would have expected that bankruptcy practice would evolve and eventually depart from the new Code’s statutory design. And that seems to have been the case. Early studies of the new system suggested that, in practice, the debtor had too much control, to the detriment of creditors.

A decade later, other researchers called for reform advancing the hypothesis that the Chapter 11 process was fundamentally flawed in part because debtors’ management had control and had become the true beneficiaries. Little more than a decade after that, creditors were claimed to be in control, owing to contractual arrangements with the debtor. The literature has been extremely rich and, in response to observations about how the system actually works, there have been calls for contractual substitutes and a near declaration of death for Chapter 11.

While the inferences scholars have drawn from the limited data are wide-ranging, the simple point here is that in vibrant business law areas like reorganization, the evolved practice often produces outcomes that seem quite different from the statutory design. This ought to be of central importance to the comparativist and should inject a note of modesty into one’s willingness to make policy recommendations based on the statutory design of another’s legal system. On the other hand, the comparativist who takes another’s statutory system (like China’s) at face value to stimulate thought about one’s own system might wonder how different (or even similar) the two systems actually are in practice. This, in turn, might stimulate hard thinking about the economic, business and legal practice dynamics that produce divergence between statutory design and practice. Are those underlying dynamics the same or different across fundamentally different legal systems and cultures?

61. See generally LoPucki, supra note 40.
63. See Skeel, supra note 11.
III. ANALYSIS

Congress put substantially more power into the hands of the debtor in the 1978 rewriting of the bankruptcy law. The pre-1978 system more closely resembled the Chinese system. An array of empirical and ideological assumptions support the choices that are reflected in the statute. We will consider here both conventional explanations for debtor control, articulated by Congress and commentators, and an unconventional explanation that one might infer from the data.

A. Conventional Rationales for Giving the Debtor More Control

The 1978 Bankruptcy Code brought former Chapters X, XI, and XII into a new Chapter 11. In the process, the consolidation opted for the former-Chapter 11 practice of leaving the debtor in charge and running the business after the filing. Congress left a detailed record of its reasons for this substantial change. As mentioned earlier, Congress believed that in many cases creditors would benefit from both the saved expenses of avoiding a trustee, and the business continuity that would result from precluding a change in management.

However, bankruptcy is a creditor-driven process and, at least in theory, creditors ought to have control. Indeed, Congress recognized that the theoretical source for the bankruptcy process was that of creditor control over a “trust” consisting of the insolvent debtor’s assets. The assets of an insolvent debtor “belonged” to its creditors in part because non-bankruptcy law (in the form of what is called the “absolute priority rule”) puts creditor interests ahead of the debtor’s owners’ interests in any distribution. Conceptually, then, the bankruptcy process simply created a trust consisting of those assets and put a “trustee” in charge of administering them for the benefit of the creditors. Logically, creditors ought to be in ultimate control of the trust (the bankruptcy estate), and the debtor should have very little to do with any of it. Bankruptcy systems such as our former Chapter X and China’s new law hew closely to such a model.

There were several sources for Congress’s counterintuitive move from a largely “creditor control” system to a “debtor control” system in the 1978 design. These stemmed from a recognition that bankruptcy practice—the “law in action”—under the pre-1978 law had diverged dramatically from the statute’s underlying theory.

First, as mentioned above, Congress found that under the old law creditors did not, in fact, exercise their rights of control. As a result, in cases where there were

66. Chapter X was designed for large public corporations and was described by Congress as “rigid.” House Report, supra note 39, at 221-22.
68. Id.
assets available, lawyers took over, making the real beneficiaries in large cases those who administered them.\textsuperscript{72} Secondly, Congress understood the rationale for business reorganizations to be capturing the going concern value of the business, which is larger than its liquidation value. That leads to rehabilitating the business instead of carving it up and selling it.\textsuperscript{73} In turn, this required the presence of the debtor and its management in order to maintain the business and thereby derive its going concern value. Perhaps more important, Congress believed that speed in the process of reorganization would be increased (and its costs decreased) by leaving the debtor in control.\textsuperscript{74} Finally, Congress believed that the debtor ought to enter the reorganization process before it is too late to be of help.\textsuperscript{75} The combination of these ideas explains a great deal, including why debtor control remains in the U.S bankruptcy statute despite a flood of criticism from many different perspectives.\textsuperscript{76}

The “debtor control” aspects of the Code deliver a group of policy decisions that Congress thought would make it easy and relatively painless for the management of troubled debtors to use bankruptcy. Financially-troubled debtors might use reorganization law directly, in an effort to formally reorganize, or use the law indirectly as leverage to reorganize without entering bankruptcy at all. Since the debtor and its management would, under the statute, remain in control, those in central management who will make the bankruptcy decision would not fear for immediate loss of their power or jobs.

Because management’s future is directly related to the viability of the business, the possibility of using the bankruptcy law for effective rehabilitation could be seen as a positive incentive for a decision to enter bankruptcy in the first place. But these incentives might be incomplete unless the owners were able to share in any positive outcome produced by the decision to seek bankruptcy protection.\textsuperscript{77} Congress added these incentives through its approach to formal rules for confirming a plan of reorganization.

\textsuperscript{72} Id. at 92.
\textsuperscript{73} Id. at 220. The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.
\textsuperscript{74} Id. at 222.
\textsuperscript{75} Id. at 231.
\textsuperscript{76} The criticism began in the early 1980's with two empirically-based articles that argued that the new Code had shifted from a “creditor control” system under the 1898 Act and its amendments to one of “debtor in full control.” See LoPucki, supra note 40.
\textsuperscript{77} The balancing of incentives to retain management has shifted over the years. Potential management incentives were seriously reduced in the 2005 amendments with the addition of Code section 503(c). See 11 U.S.C. § 503(c) (2005). This provision places strict controls on the ability of reorganizing companies to reward their management through generous executive pay packages and contracts. Pushing, perhaps, in the opposite direction are cases such as In re Global Home Prod., LLC, 396 B.R. 770 (D. Del. 2007), and In re Dana Corp., 358 B.R. 567, 575 (S.D.N.Y. 2006), where courts have either approved executive compensation plans or found that the rule does not apply to them.
A central conceptual question in a reorganization case involving an operating but insolvent business is whether the absolute priority rule should require that creditors get the going concern value of the insolvent business or, alternatively, only its (smaller) liquidation value. The practical aspects of this choice overshadow the conceptual. If creditors in a reorganization are entitled only to the liquidation value, the reorganization process will be of no benefit to them. If, on the other hand, creditors are entitled to the entire going concern value, then the owners have no interest in the reorganization in the first place and have no reason to cooperate in the rehabilitation.78

Congress seemed to believe that the core question of whether (and to what extent) creditors should be entitled to going concern value in a reorganization would be better answered through negotiation than either litigation or strict rules.79 In typical American fashion, Congress therefore created a process designed to produce negotiated outcomes to this centrally-important question.80 To make a very complicated set of provisions overly simple, the Code provides that the absolute priority rule need not operate if the Plan of Reorganization is agreed to by all the voting classes within the Chapter 11 case.81 This means ownership can share in the going concern value only if it can get its creditors to agree to the Plan; ownership loses everything if the Plan must be forced on even one class of creditors.

The confirmation rules82 reinforce the central place of negotiated outcomes in modern U.S. bankruptcy law. The leverage the debtor acquires from the existence of the bankruptcy law in its current form tends to encourage negotiation with creditors more possible. The confirmation rules give the debtor substantial motivation to reach an ultimate outcome that its creditors can agree to. The underlying design, to encourage negotiated outcomes, reflects a belief that negotiated outcomes are, as a policy matter, better than outcomes generated by other means. This is particularly true when compared with outcomes determined by government officials.83

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78. It is very debatable whether incentives such as these work the way one might anticipate. Managers and owners, for example, might be induced to cooperate by not being discharged immediately, or by being offered other benefits. Whether adding the promise of a share in the future business is necessary to optimize management's incentives is an imponderable.


80. Id.


83. The extreme version of this view is the argument that bankruptcy law is not needed at all; that parties ought to be able to contract for the insolvency regime they desire. E.g., Schwartz, supra note 64. The policy soundness of negotiated outcomes depends critically on the fair participation of all affected parties. The "contract bankruptcy" idea has been criticized as omitting important parties from a fair negotiation. See, e.g., Susan Block-Lieb, The Logic and Limits of Contract Bankruptcy, 2001 U. ILL. L. REV. 503 (2001); Warren & Westbrook, supra note 16.
B. An Unconventional Rationale for Debtor Control

In the United States, debtor control and largely-absent governmental supervision means that many debtors enter Chapter 11 when they are not economically viable, that is, when they should be in liquidation. Indeed, researchers have identified that one of the central problems in U.S. bankruptcy law is the absence of any mechanism to end businesses that are not economically viable when they enter Chapter 11. The U.S. system, in effect, supports businesses that are not economically viable for a time period before concluding under bankruptcy law that they are not legally viable and turning them to liquidation. In that passage of time, there is likely some deterioration of the value ultimately distributed to creditors. More intrusive supervision of the debtor, which is something that seems more likely to occur under the Chinese system, could reduce this problem and bring non-viable businesses to their end faster.

But in this respect, the U.S. system can indirectly deliver a benefit that is sometimes overlooked by those who analyze the law solely in its capacity to bring returns to creditors. The end of a business, particularly a large one, produces economic shock that affects not only creditors, but also non-creditor “dependents” ranging from trade suppliers to corner lunch stands. Economic systems have built-in mechanisms to soften the effects of such economic shocks on non-creditor dependants. In the United States, unemployment compensation is probably the most visible example, but job training programs, small business loans, and even personal bankruptcy fill various “social safety net” needs within the U.S. system. If one looks at the statutory design of U.S. reorganization law as a component of this set of policies, one brings a different set of criteria to evaluating the U.S. reorganization law.

Bankruptcy reorganization in the United States can be seen as a de facto component of that safety net—a shock-absorber for sudden economic change. As long as a business is legally viable (that is, as long as it cannot be put involuntarily into Chapter 7), the U.S. system will postpone liquidation for at least six months, but usually more. Those businesses that successfully reorganize and continue as businesses will have eventually delivered the going concern value that is one of the underlying premises for reorganization in the first place, and will have continued to nurture many of the non-creditor interests that depend on them as well.

84. See LoPucki, supra note 42.
85. Id.
87. See generally LoPucki & Whitford, supra note 47. The numbers of such cases may well be diminishing. See Baird & Rasmussen, supra note 65, at 752.
Under the 1978 Code, many non-economically viable businesses are effectively permitted to limp on for a period, sustained by hope. Even here, reorganization arguably has performed a positive service for those touched by these non-viable businesses. A Chapter 11 petition can act as a formal signal by a distressed debtor that in a year or so the company will end operations through liquidation. Such a signal will inevitably come earlier than a formal notice of liquidation and, in the meantime, those dependent on the business, both creditor and non-creditor alike, will have had a better chance to adjust to the now-clearly unstable economic reality. The signal will also be clearer than the symptoms of economic distress that the debtor may or may not exhibit.\footnote{88}

This “information function,”\footnote{89} if implemented soon enough, allows reorganization to facilitate self-adjustment by those who are, in one way or another, dependent on the viability of the business. It can, therefore, reduce the total economic losses inevitably inflicted. For example, a taxing authority that can prepare in advance for a loss of the debtor’s tax revenue will likely suffer fewer actual losses than the taxing authority that is surprised by the debtor’s sudden demise.\footnote{90} While adjustment time is not an actual bankruptcy distribution, it may nonetheless be helpful and valuable to those who cannot adjust to economic change as rapidly as change might occur.\footnote{91}

Many commentators operate under the assumption that a slow reorganization process is inefficient.\footnote{92} Perhaps it is. But an economic analysis that considers the

\footnote{88.\ No doubt, in some cases, the symptoms of financial distress will be obvious to anyone paying attention; a bankruptcy filing will nonetheless be less subject to rosy interpretation by observers.}

\footnote{89.\ Thank you to my colleague, Jonathan Lipson, for identifying for me this phenomenon as an “information function.” In a slightly different context, see Christine E. L. Tan, \textit{The Asymmetric Information Content of Going-Concern Opinion Opinions – Evidence from Bankrupt Firms With and Without Prior Distress Indicators}, WORKING PAPER SERIES, Apr. 2002, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=313025, where the author argues that auditors’ going concern opinions that give advance notice of financial distress add important information to the market in cases where the financial distress is not obvious. That advance notice softens the market shock that would otherwise occur with a sudden bankruptcy filing. \textit{Id.}}

\footnote{90.\ Thank you to my colleague, Amy Boss, for this suggestion.}

\footnote{91.\ It is easy to criticize this position. Among other things, it tends to collapse the distinction between parties with a contract and parties without one. Moreover, the “benefits” for non-creditors will likely come at the expense of the actual creditor distributions that will suffer during the time the debtor was in (but “should not have been in”) reorganization. I do not find any of this particularly troubling because there is no first principle that dictates what given creditors should receive in those cases where their contracting partner has encountered a financial disaster. The positive law determines what contracting parties are ultimately expecting, and bankruptcy law can legitimately alter creditors’ non-bankruptcy expectations once a debtor enters bankruptcy. \textit{Cf.} Warren, \textit{supra} note 86, at 770. While no one has proposed that non-creditors receive actual distributions in reorganization cases, some are undoubtedly “beneficiaries” of the reorganization process. Several commentators have suggested a more “visible” role for them. \textit{See e.g.}, Karen Gross, \textit{Failure and Forgiveness: Rebalancing the Bankruptcy System} (Yale University Press 1997); Nathalie D. Martin, \textit{Noneconomic Interests in Bankruptcy: Standing on the Outside Looking In}, 59 OHIO ST. L.J. 429 (1998).}

\footnote{92.\ See Michael Bradley and Michael Rosenzweig, \textit{The Untenable Case for Chapter 11}, 101 YALE L. J. 1043, 1045 (1992) and authorities there cited.}
transaction costs and other effects of financial demise on all, creditors and non-creditors alike, who were dependent on the non-viable debtor, might ultimately conclude that the current Chapter 11 process, slow and cumbersome as it can be, is actually more efficient than one that quickly and decisively carves up non-viable business debtors.93

If reorganization bankruptcy is to deliver this kind of indirect benefit for those dependent on businesses that ultimately collapse, it is essential that the business enter reorganization soon enough, while it is legally viable. That is, reorganization must not be hopeless.94 It is here, using a broader vision of a reorganization’s beneficiaries than is conventional,95 that moving to a system of debtor control could predictably make a positive difference in the United States.

Congress intended to increase the use of the reorganization process96 and there is no doubt it succeeded. Reorganization filings surged in the wake of the 1978 Bankruptcy Code.97 Nearly all reorganization filings are voluntary.98 Without the debtor’s consent, many of those cases cannot be converted to liquidations prior to the end of the exclusivity period.99

As designed, the reorganization system in the United States signals to all those involved with the business that they should proceed with caution and might do well making other economic plans. It allows creditors and non-creditors alike the time to adjust to a different economic future, one that will almost inevitably be less dependent on the debtor. Viewed as a system supplying economic adjustment time to those dependent on financially-troubled businesses, one can probably call the Congressional design a qualified success.100

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93. Conceptually, a transaction cost analysis would consider the total transaction costs (primarily legal and administrative expenses) involved in addressing all of the economic ripple effects of a business’s rapid dissolution and compare those costs to those of the current system where self-adjustment for those affected by the debtor’s demise is more likely. Compare Ian R. Macneil, Efficient Breach of Contract: Circles in the Sky, 68 VA. L. REV. 947, 953 (1982), with Daniel Friedmann, The Efficient Breach Fallacy, 18 J. LEGAL STUD. 1, 6-7 (1989).

94. Unsecured creditors can move to convert a case to Chapter 7 but will succeed only if a reorganization is demonstrably futile. WARREN & WESTBROOK, supra note 16, at 429-30.

95. See Martin, supra note 91, at note 2.


99. This might be changing as well. Businesses need cash flow in order to reorganize. In cases where nearly all the assets of the business are encumbered or otherwise unavailable – an eventuality made more likely by the 1998 revision of UCC Article 9 and the development of securitization – debtors will find it difficult to resist involuntary liquidation. This fact may have led to an observed increase in contract arrangements between the debtor and others, arrangements that have the potential to undermine many of the benefits of the reorganization process.

100. A perception of these indirect benefits partly explains the debates between those vying for “contract bankruptcy” and those opposing it. See Martin, supra note 91. Allowing creditors
If adjustment time for those affected by the business was a feature of Chapter 11 as designed, the central role of agreement in the process has the potential to undermine that function. Contract arrangements between the distressed debtor and others seem to have become common in practice; those that speed up the bankruptcy process have the potential to limit a great deal of the information that the bankruptcy process may otherwise provide to those affected by the business. Prepackaged ("prepacks") and pre-negotiated Chapter 11 cases, for example, may drastically reduce the debtor's time in bankruptcy.

Negotiations that lead to negotiated Chapter 11 plans do not include non-creditors, but one wonders whether the negotiations that lead to the pre-negotiated filing constitutes a fair process with respect to actual creditors that lack leverage. One might also question whether, in a complicated case, a bankruptcy court, creditors' committee, or U.S. Trustee can give the pre-negotiated Chapter 11 Plan the scrutiny it requires in order to be fair.

If the reorganization process as designed has been transformed by contract arrangements and if those contract arrangements have a negative impact on parties who were either intended or incidental beneficiaries of the Chapter 11 process as designed, the reorganization practice will have followed a long tradition tracing back to the sixteenth century. Contract arrangements can always have third party effects, but some contracts become valuable because they tend to extract value from third parties. Indeed, many modern business devices (e.g. personal property security interests and asset securitization) might well thrive, at least in part, because of their tendency to gain subsidies from non-parties. Given this history, the newer forms of business bankruptcy that are dominated by contract arrangements and truncate what was designed to be a more lengthy process ought to, in the words of Lord Coke in the 1601 decision in Twyne's Case, "inducunt

and the debtor to avoid the bankruptcy process by contracting for a distribution in advance will inevitably exclude the non-creditors from the process, but it will also exclude many creditors as well. The speed and returns to creditors that these systems theoretically promise may come at the expense of the wider group of beneficiaries of the bankruptcy process as broadly conceived.

102. See generally, Skeel, supra note 11; Baird & Rasmussen, supra note 65, at 752.
103. See, e.g., Lynn M. LoPucki & Joseph W. Doherty, Delaware Bankruptcy: Failure in the Ascendancy, 73 U. CHI. L. REV. 1387, 1394 (2006) (data indicates non-prepackaged, non-prenegotiated bankruptcies took, on average, about two years to complete while prepacks took less than 50 days).
104. Twyne's Case, (1601) 76 Eng. Rep. 809 (Star Chamber) (earliest example appears to be a creditor's successful challenge to a debtor-creditor arrangement as "fraudulent.") An Act against fraudulent Deeds, Alienations, Etc., 1570, 13 Eliz., c. 5.);
Thus, the value that makes these arrangements attractive may not be coming only from savings in administrative and related expenses.

Non-creditors hurt by a failing business are likely to lose more in an expedited reorganization process than otherwise. If history is any guide, so might small creditors without the leverage to participate in the pre-filing negotiations, unless the process is carefully monitored (and in a complicated large case that may be nearly impossible). When statutory design and practice diverge enough, one can expect a legislative correction, and a corresponding new process of action and reaction. This makes comparative study a moving target and more difficult; it also makes it far more interesting.

IV. CONCLUSION

In 1978, Congress concluded that creditors did not exercise the control that had been a premise of the earlier system, so it moved to a system commonly described as “debtor control.” China’s bankruptcy system, a “creditor control” system, does not contain the kinds of incentives the current U.S. bankruptcy system uses to induce troubled debtors to voluntarily enter the bankruptcy system. Bankruptcy in China implies outside supervision of the debtor and limitations on debtor access. On the surface, creditors are in control in Chinese reorganizations.

The deep cultural differences between China and the United States, among other reasons, make it hazardous to guess whether creditors in China will behave differently than the creditors who existed in the United States from 1938 through 1978, that is, whether creditors in China will initiate bankruptcy when it is “needed” or will participate adequately to make the system operate properly. Bankruptcy scholars will want to study whether Chinese reorganizations in fact begin soon enough to be successful. But a study of the actual operation of the “law in action” in China may reveal a great deal more.

Data in China may eventually show, as it does in the United States, that reorganization practice develops in important divergent ways from the statutory design. But how and in what ways will this divergence occur? Because in China there is relatively more outside control over the reorganization process and relatively less reliance on consensual arrangements, one might guess that there would be a slower rate of divergence.

There are greater differences, however, that might make the process of divergence itself worthy of study, particularly in business law areas. China’s free market system has stood alongside its legal system for only a few decades.

107. The full Latin, “bona fide; et clausulae inconsuet’ semper inducunt suspicionem,” roughly translates to “in good faith; and unusual clauses always create a suspicion.” THOMAS TAYLOR, THE LAW GLOSSARY: BEING A SELECTION OF THE GREEK, LATIN, SAXON, FRENCH, NORMAN AND ITALIAN SENTENCES, PHRASES AND MAXIMS FOUND IN THE LEADING ENGLISH AND AMERICAN REPORTS, AND ELEMENTARY WORKS 49 (Lewis & Blood, Law Booksellers and Publishers 1855) (1858). The clause that created suspicion in Twyne’s Case was the assertion in the conveyance that the gift was made honestly, truly, and bona fide. Twyne’s Case, 76 Eng. Rep. 809.
Cultural attitudes towards its legal system and to indebtedness are no doubt different than such attitudes in the United States. We might expect that the legal system's relationship to business actors and the legal system's reaction to business lawyers' efforts to innovate around and through legal restrictions could be very different as well.

This is worth serious attention because how this process of legal reform and business practice reaction will manifest in China is probably unknown at this point in China's legal and market development. While cultural differences might cause them to work very differently, we can probably expect China's business lawyers to work around what they perceive as restrictions on their clients' market activity, and we can eventually expect policy corrections or reactions by government in response to this activity. A better understanding of how this process works may well be essential to a fuller understanding of Chinese business law and to making better policy decisions related to it.

Reorganization law has proven to be an ideal area for observing this process of legal change and business adaptation in the United States. With its new reorganization law and vibrant and volatile economy, Chinese reorganization “law in action” will probably be a gold mine for any researcher willing to begin the digging.