CONTRACTUAL CORPORATE-INSOLVENCY RESOLUTION IN TRANSITIONAL ECONOMIES

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Abstract

Contractual resolution of large-enterprise corporate insolvency offers potential advantages over judicial valuation or auction, particularly in transitional economies, perhaps including China, where courts and markets may be unaccustomed to valuation of large enterprises. This is not a claim that contractual resolution is a panacea. But a contractually implemented Chameleon Equity capital structure as proposed here—like the bail-in structures adopted in Europe—could serve as an efficient tool in the transition of state-owned enterprises to privately financed entities.

I. INTRODUCTION

The standard approach to corporate insolvency in the United States is known as Chapter 11. The idea behind Chapter 11 is straightforward: because firms can fail financially but nonetheless retain economic viability it may be beneficial to investors and to employees that an insolvent firm be restructured or sold as a going concern rather than liquidated piecemeal. Consequently, upon a company's filing of a Chapter 11 petition, creditor collection efforts are suspended, and a bankruptcy court supervises the disposition of the company's assets.

Such disposition may be the cancellation of pre-bankruptcy claims and interests replaced by new (less burdensome) debt and new equity, with these new claims and interests distributed to the holders of old claims based on the priority of such claims. Or the disposition may be a sale of the debtor's assets—with the company's business intact—free and clear of old claims and interests, with the sale proceeds distributed to holders of old claims, again based on the priority of such claims. Only if the bankruptcy process reveals that the company is worth more in piecemeal liquidation than as a going concern will the assets of the debtor be sold independently of one another with the proceeds then distributed to creditors, once more according to claim priority.

In principle, then, Chapter 11 works ideally. An insolvent company's assets are put to their highest and best use—whether that use is facilitated through liability restructuring or sale—and the value generated by such use are assigned to the pre-bankruptcy creditors who might not be paid in full but will be paid as much as possible. Practice, however, may not follow this principled ideal.

Consider, for instance, the restructuring option, where the debtor's assets are held together, and old claims and interests are replaced by new. Until the turn of the 21st century, this process was routine in the resolution of insolvency among large, publicly-traded United States companies. A court faced with a decision of whether to restructure an insolvent debtor needs to estimate the value of the debtor's assets. Such valuation serves two purposes. First, valuation serves the need to determine whether the assets are worth more kept together than sold off separately, otherwise no restructuring should be approved, and the assets should simply be liquidated. Second, assuming that restructuring is appropriate, valuation serves the need to determine the relevant entitlement of the pre-bankruptcy creditors and shareholders: the greater the value of a debtor's assets the greater the distribution to junior pre-bankruptcy claims or interests.

So judicial valuation is essential to restructuring, but the valuation process can be fraught, with holders of senior claims arguing for low valuation while holders of junior claims argue for high valuation. The court is forced to cull truth from advocacy and the difficulty in doing so has led many scholars and other commentators to recommend that the law discard corporate restructuring in favor of a judicial auction conducted by a bankruptcy court. In such an auction, potential purchasers can bid for the company's assets as a going concern or piecemeal with the court approving a sale on the bid or bids that generate the most value for the bankruptcy estate and, thus, for the pre-bankruptcy creditors. Under this process, valuation is determined by the market, where bidders put their own money on the line, rather than by a disinterested judge who might lack the wherewithal accurately to estimate value despite her best efforts and intentions.

Although critics of a sale alternative to bankruptcy restructuring point to the costs of selling large firms and the limited reliability of markets, in recent years, proponents of the sale option have largely won the day. Although many United States firms are still restructured in bankruptcy, and although there has been no significant statutory change, there has been a strong trend away from liability adjustment and toward using the corporate reorganization process simply to auction a debtor's assets for the benefit of creditors. Frequently such sales are of assets as a going concern, though it is not uncommon for firms to undergo liquidation sales instead.

There is an ongoing debate in the United States over whether the shift from restructuring to auctions is a positive or a negative development. Proponents of auctions argue that markets are more accurate and less costly than judicial valuations. Proponents of restructuring argue the opposite.

Often overlooked in the debate over method of insolvency resolution is the fact that for the United States and other established capitalist economies, there may be little at stake in the argument. Judges in the United States and perhaps in other countries with similar economies have experience in asset valuation as part of the legal process, not only in bankruptcy law but in other fields as well, such as corporate law. Moreover, though choosing among valuation arguments made by litigants and their experts is not an exact science, judges in countries accustomed to an adversarial system in business litigation have years of precedent to rely on in separating message from noise in valuation disputes. Therefore, it may be that in the United States and similar jurisdictions, judicial valuation, while imperfect, is effective. Similarly, in the same established capitalist jurisdictions, market actors have vast experience in valuing all sorts and sizes of business assets for purchase or sale. Thus, in these countries, auctions, while never costless, may also be effective.

Matters may be quite different, however, in economies that are in transition between central planning and capitalist competition. A government in such a jurisdiction might, for instance, wish to convert a state-owned enterprise into a privately organized firm subject to success *or failure* in the consumer marketplace. If such a firm becomes unable to meet all its obligations, there must be a process in place to address its financial distress. But what process? Corporate restructuring of liabilities on the traditional Chapter 11 model? An auction consistent with the modern trend under Chapter 11? *Either* option might be disadvantageous in a country with a judicial system inexperienced in the valuation of business assets and a market unaccustomed to the sale of large-scale enterprises.

For transitional economies, a third option might be the best approach. This option, which, in prior scholarship, I've referred to as "Chameleon Equity" would have a company and its investors agree in advance to the ramifications of insolvency and the consequent default on obligations. Under a Chameleon Equity approach, a judge would not be asked to value a debtor's assets or auction them in the marketplace, but would instead, upon an uncured default, simply allocate the firm's assets according to the design of the contract among the debtor and its investors, who would then have only themselves to blame—not an uninformed court or unreliable market—for an unhappy resolution. Even in the United States or countries with similar judicial systems and economies, Chameleon Equity or some other contractual approach to corporate insolvency may offer advantages over a bankruptcy process that relies on judicial valuation or auctions. In transitional economies, though, such advantages have the potential to be more significant. This fact has been overlooked in existing scholarship that focuses on developed market economies such as that in the United States.

The case for contractual insolvency resolution in a transitional economy is made below in steps. Next, the proposal for a contractual insolvency process is described in more detail as such proposal would apply as an alternative to current bankruptcy law in the United States. Then, a brief elaboration is offered on how transitional economies might take special advantage of a contractual insolvency approach such as Chameleon Equity. Finally, a conclusion is offered.

II. CONTRACTUAL INSOLVENCY RESOLUTION

The history of bankruptcy law in the United States along with the progress of American bankruptcy scholarship are the genesis of proposals for contractual alternatives to the corporate bankruptcy process. Such history, scholarship, and proposals are summarized in turn below. [1]

[1] The summary provided here is largely from my own prior work. *See, e.g.*, Barry E. Adler, *The Law of Last Resort*, 55 VAND. L. REV. 1661 (2002) (also summarizing prior work).

A. Historical Background

A codified bankruptcy law has been in place continuously in the United States since the Bankruptcy Act of 1898. This Act, and the law for the next eighty years, was narrow, as was the scholarly perception of bankruptcy law over that period. Both the original Bankruptcy Act and the New Deal reforms that followed were, at least in part, a reaction to a public outcry for relief from debt's burden on individual debtors, in each case offered as a substitute for inflationary monetary policy.[2] For corporate debtors, a different public outrage was at work, but again focused on the reaction to failure rather than the consequences of that reaction for new debtors who wish to borrow. The primary contribution of the New Deal's Chandler Act, for example, was a response to the condemnation by government investigators, most notably William O. Douglas. These investigators decried the perceived abuses by large banks, such as J.P. Morgan, who, it was believed, took advantage of smaller investors whenever a corporation attempted to reorganize.[3] The Chandler Act placed independent trustees, rather than creditors, in control of corporate reorganizations. The academic debate of the time, led by Douglas and his contemporaries, mirrored this preoccupation with a debtor's post-insolvency affairs,[4] with hardly a whiff of broader policy or of consequences for debtors who were not then in financial distress. This narrow approach to bankruptcy law became the standard entrenched for generations.

B. Theory Introduced by Jacksonian Creditors' Bargain

Myopia about bankruptcy law diminished with the Bankruptcy Reform Act of 1978 and the attention this reform brought to the topic. The legislation itself, which enacted the current Bankruptcy Code, remained focused on financial crisis, a retooling of the old Act's mechanics, but scholars began to broaden their outlook. Most notable in this regard was the publication in 1986 of Thomas

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[2] *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 107 (2001).

[3] *Id.* at 109-13.

[4] *See, e.g.*, George G. Battle, *The Enactment of the New Bankruptcy Law Will Check the Tendency Toward Currency Inflation*, 19 VA. L. REV. 340 (1933); William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565 (1934); Robert T. Swaine, *"Democratization" of Corporate Reorganizations*, 38 COLUM. L. REV. 256 (1938); *see also* SKEEL, *supra* note 2, at 73-127 (collecting authority).

Jackson's book, *The Logic and Limits of Bankruptcy Law*.[5] In an exegesis that defines the predominant paradigm to this day, Jackson suggests that the bankruptcy laws can best be understood as a hypothetical creditors' bargain. He argues that if creditors could speak as one, they would prefer a collective debt-recovery process to a race among individual creditors.[6] Bankruptcy law calls off such a race, which, Jackson contends, would waste resources both in the aggregate transaction costs of individual collection and through piecemeal liquidation of viable business concerns. Thus, as compared to prior scholarship on bankruptcy law, Jackson took an ex ante approach. He imagined how creditors' anticipation of a debtor's financial crisis would shape the creditors' preferences for bankruptcy law.

Jackson's approach, however, while an important advance, was still too narrow. He assumed the presence of debt as a starting point for his analysis. The ideal analysis of bankruptcy law is not so limited in scope or time. One cannot see the full picture of bankruptcy law unless one considers more fundamental decisions about the allocation of property rights and the creation of obligations or duties with respect to property or person, decisions that may precede the issuance of debt.

To understand the shortcoming in Jackson's use of debt as a starting point, observe that debt is nothing more than a particular sort of obligation. Debt is constructed of at least two components—namely, a fixed payment and the right of the holder individually to collect. Debt is not a primitive. Its components can be constructed differently or adopted in part only. This observation is critical, as so much of what appears a quintessential part of bankruptcy law *given* debt disappears in the absence of debt. Once one looks beyond debt, much of what is now associated with bankruptcy law appears less central, less significant. Further, once one disaggregates debt, and allows once seemingly important issues to drop away, it becomes possible to gain a clearer focus on first principles of financial distress.

The point here is not that careful analysis will lead, in the United States or elsewhere, to a sensible version of the Bankruptcy Code as

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5 THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).
6 *Id.*

a set of rules to govern insolvency. Since 1978, the Code has been amended numerous times,[7] and these amendments reflect Congress' gradual but inexorable, helter-skelter surrender to special interests. But careful analysis reveals that contractual remedy for a debtor's financial failure is both possible and largely desirable, a possibility overlooked in the prevailing Jacksonian model. Thus, while reason alone will not empower anyone to dismantle, one-by-one, the phalanx of Bankruptcy Code provisions that disserve, the hope is that proper analysis can be used one day by those who may, even for a moment, gain the clout to enact a single, simple provision, one that would permit debtors (and by implication their creditors) to reject rules that do not suit them. Such analysis is, in any case, an interesting academic pursuit.

C. Limitations in Jackson's Logic of Bankruptcy Law

To begin such pursuit, let's look more closely at Thomas Jackson's work, *The Logic and Limits of Bankruptcy*, which, as noted, transformed the analysis of bankruptcy law into an analysis of a collective-action problem. Creditors, Jackson reasoned, would collectively lose from an unconstrained race, effectuated by individual legal action, to grab an insolvent debtor's assets. The transaction costs of a race could be wasteful—much as the cost of military production is often characterized as wasteful in an arms race—and, more significantly for business debtors such as corporations, self-interested individual creditors could, to the creditors' *collective* detriment, dismember or otherwise destroy a financially burdened but economically viable going concern. To avoid such a race, Jackson concluded, creditors would, if only they could, agree in advance of financial distress to call off the race in favor of a collective debt-collection process.

The bankruptcy process, in Jackson's view, reflects a hypothetical bargain among creditors, who, Jackson assumes, are functionally and temporally too disparate to reach an actual collective bargain in

[7] For changes to Chapter 11 alone, *see, e.g.*, Pub. L. No. 116-54, § 2(b), 133 Stat. 1084 (2019) (added subchapter V heading and items 1181 to 1195); Pub. L. No. 109-8, title III, § 321(a)(2), title IV, § 436(b), 119 Stat. 95, 113 (2005) (added items 1115 and 1116); Pub. L. No. 100-334, § 2(c), 102 Stat. 613 (1988) (added item 1114); Pub. L. No. 98-353, title III, §§ 514(b), 541(b), 98 Stat. 387, 391 (1984) (added item 1113 and substituted "Implementation" for "Execution" in item 1142); Pub. L. No. 97-449, § 5(a)(1), 96 Stat. 2442 (1983) (substituted "subtitle IV of title 49" for "Interstate Commerce Act" in item 1166).

advance of financial distress and may be too greedy to reach one after. Douglas Baird, a frequent Jackson coauthor, and co-developer of many ideas contained in Jackson's book, has identified an entire school of bankruptcy thought as one devoted to the process of collective action.[8]

The hypothetical bargain among creditors is, in essence, a thought experiment about how holders of debt would design the ideal bankruptcy system. There is an alternative thought experiment, however, one I want to substitute here. Although there are some parallels between consumer and business debtors, I want to focus on how entrepreneurs or business firms—both "firms" here—would structure ideal investment instruments, perhaps to the exclusion of debt, to perform the collective-action function that Jackson places at the heart of bankruptcy law. This thought experiment yields a conclusion different from Jackson's. Because firms can, through investment design, both retain the benefits of debt *and* avoid the collective-action problem (except in the atypical case of substantial tort liability), firms need not issue obligations that will conflict, even contingently. Consequently, a collective-action process need not be an element of bankruptcy law at all, much less the central element. A firm that issued debt alternatives would not resolve financial crises in the same way that a debt-laden firm would, but this fact does not mean that such a firm would necessarily benefit from a bankruptcy process. Indeed, given the available options, if a firm that was permitted to contract freely found itself subject to a creditor race anyway, one might conclude that the creditors' inability to act collectively was a solution rather than a problem.

D. Broader Thought Experiment of Chameleon Equity

To elaborate,[9] the supposed benefits of bankruptcy as a solution to a creditor collective-action problem can be explained with an asserted syllogism: debtors benefit from the issuance of debt to multiple creditors; the efficacy of such issuance is threatened by a creditor collective-action problem; a solution to the collective-action problem such as that provided by the bankruptcy process—the

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[8] *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576-80 (1998).

[9] For an account that tracks this elaboration and then expands the discussion, *see generally* Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994).

corporate reorganization process in particular—is beneficial to debtors. This syllogism is simple, but false. Although it is possible to characterize my objection in a number of ways, I will focus here (for now) on the first premise: that debtors benefit from the issuance of debt to multiple creditors.

Debtors may benefit from the issuance of *fixed obligations* to multiple *investors*, but these fixed obligations need not be *debt* obligations. Functionally, debt is composed of two parts: the debtor's obligation to pay a sum certain at a time certain, and the debtholder's right to enforce such obligation with an individual collection remedy. In the standard account of debt and bankruptcy, the first component of debt—fixed obligation—is a benefit, while the second component—individual enforcement—is a harm. So my thought experiment begins with a concededly simpleminded question: If debt consists of beneficial fixed obligations and a harmful individual enforcement right, and if bankruptcy law exists to remedy the harm of the individual enforcement right, then why can a firm not simply issue fixed obligations without an individual enforcement right and thus save itself the potential trouble, and expense, of a bankruptcy process? That is, why issue the bitter with the sweet? Although this question is straightforward, there does not seem to be a satisfactory answer, at least not one that favors the bankruptcy process as a solution to a collective-action problem.

A firm may rationally issue fixed obligations because those obligations may simultaneously allow managers to hold a significant portion of a firm's residual claim and discipline managers, who face the consequences of payment default, perhaps including dismissal. The result may be harder working managers.[10] A firm may rationally issue its fixed obligations to a large number of investors because no

[10] This account is a simplification of a complicated issue. *Compare* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-20 (1976) (noting the residual claimant's incentive to maximize wealth), *with* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653 (1984) (suggesting that managers who have a substantial investment in their firms may be reluctant to invest the firm's assets wisely if the investment in question is risky). Moreover, the market for corporate control, while costly, can substitute, at least to some extent, for debt as a disciplinary device. *See, e.g.*, Peter Dodd, *The Market for Corporate Control: A Review of the Evidence*, 1 MIDLAND CORP. FIN. J. 6 (1983); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983). Suffice it to say here that it *may* be rational for *some* firms to invest their managers with a substantial residual interest and to have those managers face the risk of financial ruin for failure to meet fixed obligations.

single lender would be willing to provide all financing at all times. Or a firm might rationally prefer to have multiple financing sources so as not to vest in any lender the opportunity to behave strategically with respect to subsequent loans that only an existing lender, given better information, could efficiently provide.[11] But again, why permit each individual creditor the right to collect?

To be sure, a fixed obligation is not an obligation at all unless the debtor faces consequences for failure to pay. But it is possible to envision a remedy for failure other than the individualized remedy afforded creditors. The holders of fixed claims could have a *collective* remedy. Absent legal and other impediments, a firm could replace debt with a financial instrument analogous to preferred equity. This substitution could create what I call a "Chameleon Equity" firm.[12] Such a firm would retain the benefits of fixed obligations but would avoid the negative consequences of creditor coordination failure—notably post-default dismemberment of a viable firm—by eliminating individual creditor collection.

In the simplest Chameleon Equity firm, insolvency and uncured default would eliminate the pre-insolvency common-equity class of investors and would convert the lowest priority fixed-obligation class to common equity. This transformation would follow a grace period during which a firm's outside directors could replace management in an attempt to cure the default that triggered conversion.[13] A

[11] Virtually all bankruptcy scholarship assumes that large firms have many lenders. As Douglas Diamond illustrates, this assumption is not theoretically inevitable. *See* Douglas W. Diamond, *Corporate Capital Structure: The Control Roles of Bank and Public Debt with Taxes and Costly Bankruptcy*, 80 FED. RES. BANK OF RICHMOND ECON. Q. 11, at 30-31 (1994) (describing circumstances under which bank debt is preferable to public debt). Even a large firm could borrow from a single institution, which could in turn have diversified investors. It is plausible, nonetheless, to assume that many large firms will efficiently have multiple sources of debt capital, perhaps because a single institutional lender to a large firm would have large administrative expenses. *Id.* at 30. Moreover, a single lender or its managers, like a large shareholder or its managers, exert a powerful influence over a debtor, one that might not be in the debtor's best interests. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 826-27 (1992) (describing conflicts of interests facing institutional money managers); *cf.* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 261 (1994) (arguing that the presence of multiple parties with power can reduce side payments to any one such party); Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1, 1-3 (1996) (arguing that multiple creditors may minimize strategic management default).

[12] *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-33 (1993).

[13] Such a grace period would limit the risk of collusion between the managers and the pre-transformation junior creditor class, which otherwise might, on the side, bribe the managers to have even a solvent firm default.

Chameleon Equity transformation would not occur, then, until the capital market signaled a firm's insolvency through a refusal to refinance.[14] Post-transformation, any remaining preferred-equity class would survive unaffected. At any given time, management would represent the then-current common-equity class and could be summarily replaced by that class.[15] Investors could adopt collectivization of this Chameleon Equity structure *actually*, rather than hypothetically, through their choice to finance a firm that has eschewed traditional debt, perhaps by initial charter.[16]

Thus, for a simple firm, with one class of common equity and one class of general creditors, after an uncured default, the general creditors would become the equity class and *automatically* receive securities worth the firm's entire value. The general creditors collectively, as the new equity holders, or purchasers therefrom, would also have control of the firm, which they could operate or liquidate as they wished. There would be no need for a court to provide a collective remedy because there would be no individual remedy in the first place. Nothing else would have to change.

In a more complex firm, one with a variety of fixed-obligation priority classes, even after a default triggered a Chameleon Equity

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[14] If neither the old managers nor the newly charged special-purpose managers could cure a triggering default, then the most likely reason would be insolvency, which would justify the transformation. Consequently, managers of a Chameleon Equity firm might not have sufficient incentive to transform a firm *early enough*. But managerial desire to avoid default until the last possible moment, a desire that can be mitigated by covenants with investors, or through preference rules, would not distinguish a Chameleon Equity firm from a traditional firm under the current bankruptcy regime.

[15] This insight, to the extent it is an insight, is built on a discussion of collective action among bondholders in Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 239-40 (1987).

[16] There is other work that recognizes the role of a debtor corporation as a nexus for agreement among creditors. *See, e.g.*, Robert A. Haugen & Lemma W. Senbet, *Bankruptcy and Agency Costs: Their Significance to the Theory of Optimal Capital Structure*, 23 J. FIN. & QUANTITATIVE ANALYSIS 27, 29-31 (1988) (stating that, in the abstract, impediments to restructuring are easily eliminated through inclusion of simple provisions in corporate charters and bond indentures); Robert C. Merton, *The Financial System and Economic Performance*, 4 J. FIN. SERVICES RES. 263, 283-85 (1990) (suggesting that options could eliminate the need for bankruptcy); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647-48, 669-75 (1992) (arguing that secured credit mitigates the collective-action problem); Roe, *supra* note 15, at 232, 250-69 (arguing that prohibition under section 316(b) of the Trust Indenture Act restricts contractual resolution of financial distress). But none of these contributions has recognized the potential completely to solve the collective-action problem without a substantial restriction on the capital structure flexibility available to firms that rely on the bankruptcy process to cure any collective-action problem. For example, an all-equity capital structure solves the collective-action problem but does not preserve the advantages of fixed obligations. This observation is not meant to diminish the contributions of others, but simply to note an advance. *Cf. infra* note 20.

transformation, no judicial intervention would be required to preserve the highest priority obligations (which could include asset-based secured obligations). After the firm, relieved of its most junior obligations, cured any payment default on its senior obligations, the senior obligations would retain their priority and would survive complete with fixed claims of original maturity. This process would free the firm to adopt a tiered hierarchy of priority classes that would keep the firm almost eternally solvent and almost eternally subject to significant fixed obligations. In the end, every claimant would get the priority for which it contracted. (Tort law could award nonconsensual creditors a Chameleon Equity obligation of any priority, including the highest, rather than a creditor's claim.) Although there would be questions of default and liability, as there are now in traditional firms, there would be no post-insolvency restructuring expense. A Chameleon Equity firm would have to bear the initial transaction cost of adopting the Chameleon Equity structure. But it is difficult to imagine that this cost would be more than a trivial addition to the current cost of contracting for corporate charters and bond covenants.[17] Corporate bankruptcy, then, seems unnecessary, at least in terms of this simple thought experiment.

This said, I am not so naive as to believe that abolition of bankruptcy or widespread adoption of a Chameleon Equity structure is imminent or even possible. In the United States, for instance, there are legal and other impediments to a Chameleon Equity structure. These barriers include tax, commercial, corporate, and tort law, and there is a public choice explanation for the persistence of these impediments.[18] Nevertheless, absent artificial constraint, a world without debt or bankruptcy, and with contractual solutions to the collective-action problem, seems a potentially efficient world.[19] At

[17] This point is discussed in Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1118-19 (1994). In Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669, 720 (1993), the author describes these costs as "immense," because he neglects the possibility that the contracts could become standard form much like bond covenants.

[18] *See* Adler, *supra* note 12, at 333-41.

[19] As evidence in support of this proposition, there are significant similarities between Chameleon Equity and the European "bail-in" solution to the risk of insolvency in systemically important financial institutions. *Cf.* David Crow, *European Banks Issue Record 100 Billion Euros of 'Bail-in' Debt in 2019*, FINANCIAL TIMES (Dec. 30, 2019).

the very least, such a world need not include Jackson's conception of what is essential about bankruptcy.[20]

As a final note in this thought experiment, it is important to keep in mind that the difference between Chameleon Equity and corporate reorganization under the Bankruptcy Code is not merely semantic. The two approaches differ fundamentally on the treatment of claims or interests with different levels of priority. Each attempts to honor what is known as "absolute priority;" that is each seeks to compensate high-priority claims in full before lower-priority claims are compensated at all. But the processes are distinct. As described above, Chameleon Equity relies on ex ante prediction about valuation at the time of default—i.e., the prediction that a firm's common equity alone is entitled to no distribution in the event of such default—while the Bankruptcy Code relies ultimately on judicial determination of the firm's value at the time of bankruptcy. Still other approaches, such as a mandatory auction in the event of a debtor's uncured default, would use the market to assess value at that time.

III. CORPORATE INSOLVENCY IN TRANSITIONAL ECONOMIES

The analysis here has now come full circle. Although the foregoing explains that a contractual resolution of a corporate debtor's insolvency is possible, also noted is that resolution through corporate restructuring or sale is also possible. The essential question, then, is which approach works best. For transitional economies, where neither judges nor investors are experienced in the valuation of large enterprises, or where those in control of distressed firms lack the political incentive efficiently to resolve a firm's

[20] Others have seen the potential for transferring equity in satisfaction of debt or transforming debt into equity. *See, e.g.*, Merton, *supra* note 16, at 263, 283-85 (suggesting a debtor's option to pay claims and retain equity in underlying assets); Note, *Distress-Contingent Convertible Bonds: A Proposed Solution to the Excess Debt Problem*, 104 HARV. L. REV. 1857, 1869-77 (1991) (recommending a gradual transformation of debt into equity as the value of a firm declines). None of these proposals, however, attempts to decompose debt into its fixed-obligation and individual-collection parts, and each thus fails to recognize the potential of financial instruments stripped of individual collection rights to mimic any other feature of debt, including multiple priorities, through simple decoupling. Ironically, a reform proposal often described as roughly equivalent to Chameleon Equity, presented in Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992), lacks the essential element of Chameleon Equity, namely the elimination of individual creditor collection. *See* Adler, *supra* note 12, at 332-33.

financial crisis, a contractual solution may be optimal, albeit imperfect.

In support of this proposition, it can be noted that China, the world's leading transitional economy, has had only mixed success in addressing the insolvency of its state-owned enterprises (also known as SOEs). As the World Bank reported at the turn of the new century:

> The bankruptcy regime in China has had a number of positive outcomes. It has allowed the bankruptcy of more than 20,000 enterprises, of which more than half were SOEs. In the process, it has reallocated many assets, often to stronger firms, to more efficient uses, and/or to non-state operators. Most fundamentally, this has been achieved while maintaining social stability and avoiding financial system collapse. Moreover, the, system has built practical experience in courts and local administrations, as well as in valuations and auctioning, and it has helped to create some public understanding of bankruptcy, and acceptance of the principle by workers and officials.
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> However, these achievements have come at high costs. With social stability and municipal development interests prevailing over creditor interests, creditors have generally achieved very low recovery rates. This result has affected banks' balance sheets directly; has deterred banks from initiating bankruptcy themselves; and has affected their willingness to lend.[21]

Although this passage credits the Chinese system with building experience in judicial process, valuation, and auctions, the World Bank's conclusion that the process has left creditors unpaid and unwilling to lend suggests that such experience has not yet reached the levels attainable in more established systems such as in the United States.

Moreover, it does not appear that matters have improved significantly since the World Bank's report. Consider this recent assessment from the Peterson Institute of International Economics:

[21] WORLD BANK, BANKRUPTCY OF STATE ENTERPRISES IN CHINA: A CASE AND AGENDA FOR REFORMING THE BANKRUPTCY SYSTEM (2000).

> China's economic growth in recent years has been hobbled by the many long-term money-losing firms, often state-owned, dubbed as "zombie companies" because they are effectively insolvent but kept alive only by continuous bank loans and government subsidies. From 2008 to 2018, China's nonfinancial corporate debt grew more than fourfold, from $4.56 trillion to nearly $20 trillion, according to the Bank for International Settlements. The International Monetary Fund (IMF) estimates that zombie firms constituted almost one tenth of all nonfinancial corporate debt in China in 2016.
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> The Chinese government has repeatedly bailed out these unsound companies rather than let them fail, avoiding the pain of layoffs, tax revenue losses, and write-offs of loans that would require banks to rebuild their capital. Keeping these zombie companies alive has produced overcapacity in many sectors and chronic resource misallocation.
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> China is hardly unaware of the problem. Since launching a deleveraging campaign to systemically reorganize its economy in 2016, Beijing has been nibbling away at its zombie problem through bankruptcies. Between 2015 and 2018, the number of enterprise insolvency cases, involving firms with all forms of ownership, that were accepted and adjudicated annually by the Chinese legal system grew roughly fivefold. The burgeoning cases can be partly attributed to the establishment of 98 specialized bankruptcy courts by the end of 2018.[22]

This report goes on to say that, despite the government's efforts, and its objective to liquidate for the benefit of creditors inviable—i.e. "zombie"—firms, bankruptcy practice has not evolved sufficiently to achieve this objective (the World Bank's earlier optimism about the development of courts and financial markets notwithstanding). Thus, the time might be ideal for China, and similarly situated transitional economies, to consider a contractual alternative to the bankruptcy process.

To illustrate this proposition, imagine that a nation such as China wishes to privatize a state-owned enterprise, say an auto

[22] Tianlei Huang, *China is Only Nibbling at the Problem of "Zombie" State-Owned Enterprises*, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS (August 23, 2019). https://www.piie.com/blogs/china-economic-watch/china-only-nibbling-problem-zombie-state-owned-enterprises.

manufacturer, and does so through the grant of equity in the company to its workers. Assume that the workers, now shareholders, have the company raise additional capital through the issuance of RMB100 billion in senior debt and RMB100 billion in junior debt. Assume that after some years of operation both the senior and junior debt become due but that the company is unable to pay all of the debt in full. Assume further that at the time of the imminent default, the company's assets are worth RMB150 billion. Consequently, if absolute priority is to be honored, holders of the senior debt should receive RMB100 billion in value, holders of junior debt should receive RMB50 billion in value, and shareholders, who have not managed to have the firm meet its expectations, should receive nothing.

Absolute priority might be achieved for this illustration in at least three ways. First, if a bankruptcy court accurately determined the company's value as RMB150 billion, the court could restructure the company, issuing two thirds of all new claims and interests to holders of the pre-bankruptcy senior claims and one third of such new claims and interests to holders of the pre-bankruptcy junior claims. Second, if there existed an adequate market, a bankruptcy court could sell the company's assets free and clear of prior claims and interests for RMB150 billion, then distribute RMB100 billion to holders of the pre-bankruptcy senior claims and RMB50 billion to holders of the pre-bankruptcy junior claims. A third way exists for absolute priority to be honored if the company had upon its privatization adopted a Chameleon Equity capital structure. Under such structure, upon the company's default, the pre-bankruptcy shares would be cancelled, the pre-bankruptcy junior claims would be converted to equity, and the pre-bankruptcy senior claims would remain outstanding, entitled to RMB100 billion, leaving the new shareholders (formally holders of junior claims) the RMB50 billion equity surplus.[23]

These are *in principle* three ways to honor absolute priority. Practice may not follow principle, however, particularly in a transitional economy without judges or markets accustomed to the

[23] The numerical example in this illustration is, of course, simplistic, ignoring, for instance, transactions cost and the effect interest rate has on the value of debt obligations. But incorporation of such factors into the illustration would needlessly complicate the exposition; omission of these factors does not detract from the essence of the illustration.

valuation of large enterprises. Judicial valuation may be difficult as there may be few comparable enterprises, and although the process could include expert valuation by economists—as occurs in the United States, e.g.—the experts themselves might have little foundation for their opinions. Economists look to markets for the basis of valuation and if the market for assets such as those owned by the debtor auto company is not robust (perhaps because the jurisdiction in question does not permit foreign ownership of these or similar corporate assets), then the experts, presumably outsiders to the company, may be of little use. It follows, of course, that resort to an auction would fare no better under these assumptions of an inadequate market.

A Chameleon Equity structure, by contrast, would not indirectly or directly suffer from market insufficiencies. In this illustration, upon formation, the company's original shareholders, senior creditors, and junior creditors could *predict* the likely value of the company should it encounter the need to default and, more importantly, the parties could have agreed to eschew judicial or market valuation and *rely on* that prediction. If the prediction is accurate, the outcome of Chameleon Equity adoption could here be superior to a noisy judicial valuation or unreliable market sale. Moreover, a judicial valuation or auction could be not only inaccurate, but unbalanced as well. Imagine, for example, that both judges and market participants are overly conservative in assigning value to assets of uncertain worth; such a bias could tend to overcompensate senior claims.

For another, more nuanced, illustration of how a Chameleon Equity structure could yield benefits in a transitional economy, consider the following stylized facts based on an anecdotal account of a legal dispute in Russia not long after the dissolution of the Soviet Union. A holding company owns 80% of the equity in a subsidiary oil company, the remaining 20% held by an unrelated minority shareholder. The subsidiary has few liquid assets and will have difficulty paying a large debt obligation about to mature. The holding company invokes the Russian Law on Insolvency (Bankruptcy) in an attempt to initiate a sale of the subsidiary's assets, which the holding company itself intends to purchase for the total amount of the subsidiary's debt, providing full payment to the subsidiary's creditors but leaving the minority shareholder with no return.

In this illustration, the minority shareholder objects to the sale, claiming that despite the subsidiary's cash shortage, the value of its assets exceeds the total amount of its debt. If this contention is correct, and if there were a robust capital market, the minority shareholder could protect itself by raising the funds to outbid the holding company for the subsidiary's assets and thereby retain its 20% share of the firm's equity value. If the capital market provides insufficient liquidity, however, this protection may be unavailable to the minority shareholder.

In this case, the minority shareholder would argue that the holding company should not be permitted to move forward with the subsidiary's sale, which, according to the minority shareholder, would exploit the holding company's position and knowledge as an insider. The problem, though, is that, as far as the bankruptcy court may be able to determine, the manipulative actor could be the minority shareholder, not the holding company. That is, the court would have to determine a value of the subsidiary's assets to decide whether the holding company or the minority shareholder should prevail. And, as noted above, while the court could examine expert witnesses to opine on that value, experts might be of little help because they, themselves outsiders, presumably would have no more information than market investors.

Now imagine that the subsidiary in this illustration were organized as a Chameleon Equity firm and that the minority shareholder is correct: the subsidiary's assets are in fact worth more than the total amount of its fixed obligations (though no outsider, whether judge or investor, can reliably determine this truth). Here, even in the absence of an auction, there would be no default on the obligations due because the result of such default would be a cancelation of old equity shares, *including* those owned by the holding company, and a transformation of pre-default fixed obligations into equity. So, the holding company would have an incentive to refinance the obligations, thus preserving its *and* the minority's equity interest. That is, even in this perhaps atypical circumstance, a Chameleon Equity structure could prevent an improper distribution of value that might otherwise occur given deficiencies in judicial valuation or markets.

To be sure, in this illustration, even a Chameleon Equity structure could not entirely prevent the holding company from using its dominant position to exploit the minority shareholder. For example, perhaps the holding company would seek to purchase the subsidiary, at a bargain, outside of the insolvency process. Or perhaps, within the Chameleon Equity structure, the holding company would refinance the subsidiary's obligations only at an unduly high interest rate,[24] or on terms that would lead quickly to a subsequent default. Adoption of a Chameleon Equity structure would not inherently combat these process abuses. But perhaps general laws, or supplemental ex ante contracts, could. If so, contractual insolvency resolution could serve as at least part of a broader solution.

IV. CONCLUSION

Contractual resolution of corporate insolvency offers potential advantages over judicial valuation or auction, particularly in transitional economies where courts and markets may be unaccustomed to valuation of large enterprises. This is not a claim that contractual resolution is a panacea. While, as illustrated here, a contractual scheme such as Chameleon Equity can be tailored to address some strategic manipulation, there are other circumstances, not illustrated, where a contractual mechanism can itself be manipulated. Moreover, the capital structures described in this article are simpler than the claim-priority hierarchy that obtains in many countries (priority for workers' claims, for example). And while the Appendix to this article provides an example of draft legislation designed to authorize the adoption of Chameleon Equity within the framework of a more complex hierarchy (that of post-Soviet Russia), there is no doubt that such an implementation would be more difficult than illustrated here. The observations made here about the benefits of contractual insolvency resolution comprise merely a starting point for a discussion, not the end of the conversation.

[24] *Cf. id.*

APPENDIX

The following proposal was made in Moscow at the invitation of the Harvard Institute for International Development, Legal Reform Component of the Russian Privatization Center Project, 1995-1997.

Proposal for Russian Federation Company Law:
Authorization of Contractual Insolvency Resolution

Article 15A.Record of Rights to Movable Property of Company and Movable Property in a Company's Possession

1. Rights of another person to movable property in a company's ownership or possession, including rights to property which the company may own in the future or which the company may possess in the future, and rights which come into force in the presence of specified conditions, shall be recorded following the procedure provided by this article, except in cases where the person having the rights to movable property possesses the given property.

2. A company, on request by a person having rights to movable property in the company's ownership or possession shall establish a special book for recording of rights to movable property in the company's ownership or possession (company's property book).

Custody of a company's property book shall be effectuated by a notary. Information on the notary (name and address) may be included in the company's charter.

3. An entry on rights of a person to movable property in a company's ownership or possession shall be made by a person empowered by the company in the property book of the company upon the presentation of a request on recording of rights to movable property in a company's ownership or possession, with a statement of the movable property, the name and address (place of location) of the person having rights to the movable property, and a description of the rights.

4. An entry on cancellation of an earlier entry on rights of a person to movable property in a company's ownership or possession shall be made by a person empowered by the company in the company's property book upon the presentation of a request on cancellation of an earlier entry on rights to movable property, signed by the person who had the given rights, or by decision of a court.

5. An entry on cancellation of an earlier entry on rights of a person to movable property in a company's ownership or possession shall also be made in the company's property book on the expiration of a five-year period from the date of the entry on the given rights, unless the person having the rights to movable property has delivered to the company a request on extension of the entry for an additional five-year period. A request on extension for a five-year period of an entry on rights to movable property may be made an unlimited number of times.

6. A notation on replacement of the person, having rights to movable property in a company's ownership or possession shall be made by a person empowered by the company in the company's property book upon presentation of a request on replacement of the person having rights to movable property, signed by the person who had the given rights, with a statement of the movable property and the name and address (place of location) of the new person having rights to movable property.

7. The company shall make available information, included in its property book, about rights to movable property in the company's ownership or possession, in the following cases:

to a person presenting a valid request for recording of rights to movable property in a company's ownership or possession in accordance with paragraph 3 of this article;

to a person having, or having had, rights to movable property of the company in a company's possession or ownership, a record of which is included in the company's property book;

to other persons by decision of the company or a court.

8. A company shall give written notice to a person delivering a request on recording of rights to movable property in a company's ownership or possession, on making the entry. A company shall give written notice to a person having had rights to movable property in a company's ownership or possession, about cancellation of the record of the given rights or replacement of the person having the given rights.

Article 32. Rights of Creditors of Company

1. A company's charter may include provisions securing the rights to creditors in the case when the company fails to fulfill its obligations to creditors, including the provisions of this article. In the case of inclusion of the provisions of this article in a company's charter, the company and its shareholders and creditors shall follow these provisions during nonfulfillment by the company of its obligations to creditors, unless otherwise provided in the charter.

2. In the case of nonfulfillment by the company of its obligations to the creditor, the creditor has the right, after a period established by contract, to deliver a certificate of nonpayment to the company and to the state registration body effectuating registration of the charter of the company. The company has the right in good faith to deliver to the creditor and the state registration body a certificate of objection to a certificate of nonpayment.

The state registration body shall weekly publish a list of companies, with regard to which a creditor has filed and not removed a certificate of nonpayment, and the company has not objected to the certificate of nonpayment. A certificate of nonpayment shall come into force on the date of publication. The creditor has the right to appeal the company's objection in court.

3. Shares of a company whose charter includes the provisions of this article shall be considered to be the subject of a pledge to creditors, securing the obligations of the company. Execution on

this pledge shall be effectuated in the procedure, established by this paragraph.

Unless otherwise provided by the charter, in the case when a certificate of nonpayment continues in force, without objection by the company, for a period established in the charter, shareholders of the company lose all their rights and:

the issued ordinary shares of the company shall be immediately redistributed by the company's board of directors to creditors having fifth priority during liquidation of the company, in proportion to the amount of claims subject to satisfaction during liquidation of the company; and

a creditor of the fifth priority on the date of redistribution shall lose all of his rights except the right to receive ordinary shares in proportion to the amount of claims subject to satisfaction during liquidation of the company, and the right to receive payment during liquidation of the company in accordance with the order of priority established by legislation.

The company shall effectuate the redistribution of shares among creditors by cancelling the documents verifying the rights of shareholders and issuing new documents verifying the rights of creditors.

A creditor may appeal to court the decision of the board of directors on the amounts of his claims subject to satisfaction.

4. In case of redistribution of ordinary shares of the company, the board of directors shall convene a general meeting of shareholders no earlier than 30 days and no later than 60 days from the date of redistribution of shares. The members of the board of directors shall be elected by the general meeting following the procedure established by this law and the company's charter. The agenda for the general meeting shall include the issue of fulfillment by the company of its obligations having from the first priority through the fourth priority during liquidation of the company.

5. Unless otherwise provided by the charter, a creditor who has not received payment on an obligation, secured by a pledge of property of the company, in relation to whom a certificate of nonpayment has been filed, does not have the right to effectuate execution on the pledged property earlier than:

the date of holding of a general meeting of shareholders in accordance with paragraph 3 of this article; or

one month from the date of the general meeting, in the case where the general meeting takes a decision to correct any situation concerning nonpayment of these obligations.

In the case where the company, during a one-month period from the date of holding the general meeting, fully corrects a situation of nonpayment of obligations to creditors, delivering credit under security, such a creditor does not have the right to demand early fulfillment of the company's remaining obligations, unless the company's charter provides otherwise.

6. The demand of a creditor on an obligation, secured by a pledge of property of the company, remaining after the creditor levies execution on the pledged, shall be fulfilled in the same way as other obligations of the fifth priority. The creditor has the right to receive authorized but unissued ordinary shares of the company in the same proportion to the amount of his remaining claims to be fulfilled in which these shares were received by other creditors of the fifth priority in accordance with paragraph 3 of this article. During this, the number of shares to be issued to the creditor shall be decreased in relation to inflation from the date of redistribution of shares to creditors and the date of determining the number of shares to be issued to the creditor, following the procedure established in the company's charter.

In case of an insufficient quantity of authorized but unissued ordinary shares, a general meeting of shareholders of the company may take a decision to increase the quantity of authorized ordinary shares of the company following the procedure, established by this law. During failure by the general meeting of shareholders to take a decision to increase the quantity of authorized ordinary shares, the creditor, having the right to receive ordinary shares, instead receives the value of these shares.

7. In case a creditor's claim was considered invalid by the company, and a court takes a decision on the effectiveness decides that the claim is valid, the creditor has the right to receive authorized but unissued ordinary shares of the company in proportion to the amount of his claims following the procedure established by paragraph 6 of this article.

8. The provisions of a company's charter establishing rights of creditors in accordance with this article shall be considered a part of the contract between a company and a creditor, entered into after the date of adoption of these provisions. The rights of creditors of a specified priority may be reduced by way of amendment to the company's charter only with the agreement of creditors holding a larger in size (50% or more in in accordance with the charter) part of the claims of creditors of the given priority.

Article 33. Securing Rights of Creditors and Other Persons Having Rights to Movable Property of Company and Movable Property in Company's Possession

A person, having rights to movable property in a company's ownership or possession, who fails to apply for recording of its rights to movable property in a company's ownership or possession in accordance with article 15A of this Law shall have property liability for losses caused to another person who in good faith acquires the given property or rights to the given property.

Add to article 23:

If a company's charter establishes rights of creditors in accordance with article 32 of this Law, a general meeting of shareholders of a company may not take a decision on voluntary liquidation of the company, and the company may not deliver to the arbitrage court an application for initiation of a insolvency (bankruptcy) case, during a period established by the charter, which begins on the date of delivery to the company of a certificate of nonpayment, not protested by the company.