Time, Uncertainty, and the Law of Corporate Reorganizations

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Cover Page Footnote
Assistant Professor of Law, University of Mississippi Law School. B.S., Massachusetts Institute of Technology (1982); J.D., University of Virginia School of Law (1989). I thank Adam Stone, Christopher McNulty, and Kimberly Jones for research assistance that aided me in writing this Article; Dean Robert Scott and Professors Donna Adler, Richard Barnes, George Cochran, Carl Felsenfeld, Chris Frost, Saul Levmore, Lynn LoPucki, Gary Myers, Sylvia Robertshaw, Ron Rychlak, Bryn Vaaler, and Todd Zywicki for their helpful comments regarding this project in general and this Article in particular; and Professors John Breen and Andrew Klein, longtime friends, for their unwavering support. The Lamar Order of the University of Mississippi School of Law provided financial support without which this Article would not have been possible. Finally, I wish to thank the faculty and participants in the 1998 summer Austrian Economics Seminar, sponsored by the Austrian Economics Program at New York University. Of course, all errors are my own. Comments and questions are welcome at . The title of this Article is derived from Gerald P. O'Driscoll, Jr. and Mario J. Rizzo, The Economics of Time and Ignorance (1985). As I shall explain below, the word “uncertainty” is used in the sense of a lack of knowledge about facts that are too diffuse and too numerous for any one person or even one institution to know, digest, and synthesize.

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John M. Czarnetzky*

INTRODUCTION

ECONOMICS is a science of human action. The focus of economic analysis, therefore, must be the subjective perceptions, knowledge, and context of the individual acting in the marketplace.¹ The economist must account for the inescapable fact that acting persons face radical uncertainty about the future state of the world. Quite often, people are genuinely surprised by events as they unfold in time. The true challenge for the economist, therefore, is to understand and predict the individual's subjective response in the face of uncertainty about the world, rather than to derive the individual's actions solely by the objective reality surrounding him.² One logical implication of such a subjectivist approach is that the value of a good is what some individual is willing to pay for it, not a value derived from objective facts about the good.³ It is the relation of the individual to things, not something inherent in things themselves, that ought to be the focus of economics.⁴

Moreover, knowledge is highly diffused among individuals in a society. The beauty of the market is that it spontaneously coordinates, without a central authority guiding it (because no central authority

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The title of this Article is derived from Gerald P. O'Driscoll, Jr. and Mario J. Rizzo, The Economics of Time and Ignorance (1985). As I shall explain below, the word “uncertainty” is used in the sense of a lack of knowledge about facts that are too diffuse and too numerous for any one person or even one institution to know, digest, and synthesize.

1. See Peter J. Boettke, Introduction to The Elgar Companion to Austrian Economics 1, 3-4 (Peter J. Boettke ed., 1994) [hereinafter Boettke, Introduction].
2. See Steven Horwitz, Subjectivism, in The Elgar Companion to Austrian Economics, supra note 1, at 17, 17-18.
3. See id. at 18.
4. See id. at 17-18.
could), all the bits of knowledge that are necessary to produce and to exchange goods and services that suit the subjective tastes and desires of consumers.\(^5\) When there is a gap in the market coordination of knowledge, an opportunity exists to sell a good or service to consumers at a better price than any other producer.\(^6\) Entrepreneurs discover gaps in the market and seek to remedy them through action. The entrepreneur acts by formulating plans, testing those plans through a process of rational criticism, and either implementing the original plan or revising it further.\(^7\) Individual plans are sometimes coordinated with the plans of others through social institutions such as corporations. The ameliorative role of entrepreneurship means that the market itself is, unavoidably, a process that fosters the entrepreneurial search for solutions to problems and, consequently, the general growth of knowledge in society.\(^8\)

The foregoing assertions are related to the bedrock assumptions of traditional, neoclassical economics, but they are more cousins than siblings. Indeed, the traditional law and economics scholarship of the past few decades\(^9\)—with its emphasis on deriving from objective facts the efficient solution to legal problems—has not mined the notions of methodological individualism, subjectivism, and entrepreneurship in any consistent fashion, despite the manifest relevance of these ideas for those inclined to employ an economic approach to the study of law.\(^10\)

In that traditional vein, much ink has been spilled in an effort to justify the American law of bankruptcy in general, and corporate reorganizations in particular.\(^11\) Scholars have offered, from several per-

\(^5\) See id. at 19-20.


\(^7\) See generally David A. Harper, Entrepreneurship and the Market Process: An Enquiry into the Growth of Knowledge 3-44 (1996) (describing the market process as an interpersonal learning process by which entrepreneurs identify gaps in knowledge, formulate hypotheses for correcting the gap in knowledge, and revise their hypotheses until the problem is solved).


\(^10\) Law review articles that purport to apply these concepts to law are cited infra note 29.

\(^11\) See, e.g., Thomas H. Jackson, The Logic and Limits of Bankruptcy Law (1986) [hereinafter Jackson, Logic and Limits] (exploring the purposes of bankruptcy law throughout its history); Barry E. Adler, Bankruptcy and Risk Allocation, 77 Cornell L. Rev. 439 (1992) (arguing that bankruptcy law's reallocation and reorganization provisions are dangerous and lack justification); Barry E. Adler, Finance's Theoretical Divide and the Proper Role of Insolvency Rules, 67 S. Cal. L. Rev. 1107 (1994) (maintaining that bankruptcy law is misguided and its goals can be better accomplished through contract law); Barry E. Adler, Financial and Political Theories of American
Discussion on corporate bankruptcy, its financial and political theories, and the impact on the American public. Authors include Barry E. Adler, Douglas G. Baird, and Elizabeth Warren, among others, examining various perspectives on how bankruptcy law affects society and the economy.

Adler, Barry E., "Financial and Political Theories," 45 Stan. L. Rev. 311 (1993), arguing that the American public's acceptance of bankruptcy law is both a political and economic decision and offering alternative systems.


Baird, Douglas G., "Visiting Auctions in Chapter 11," 36 J.L. & Econ. 633 (1993), examining the incentives of those in control of chapter 11 auctions and the effect these incentives have on the costs of bankruptcy.

Baird, Douglas G., "The Uneasy Case for Corporate Reorganizations," 15 J. Legal Stud. 127 (1986), rejecting the accepted view that bankruptcy law should change the rights that investors enjoy outside the bankruptcy arena.


Bowers, James W., "Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure," 88 Mich. L. Rev. 2097 (1990), asserting that the tendency of bankruptcy scholars to tinker with current bankruptcy law is futile.

Bradley, Michael & Michael Rosenzweig, "The Untenable Case for Chapter 11," 101 Yale L.J. 1043 (1992), arguing that the 1978 Bankruptcy Reform Act hurts stockholders and bondholders of bankrupt firms.

Frost, Christopher W., "Bankruptcy Redistributive Policies and the Limits of the Judicial Process," 74 N.C.L. Rev. 75 (1995), arguing that bankruptcy law should discourage the importation of wealth from creditor to shareholder.


Rasmussen, Robert K., "Debtor's Choice: A Menu Approach to Corporate Bankruptcy," 71 Tex. L. Rev. 51, 55 (1992), positing that amendments to corporate charters should be constrained to reduce "the exportation of wealth from creditor to shareholder."


Roe, Mark J., "Bankruptcy and Debt: A New Model for Corporate Reorganization," 83 Colum. L. Rev. 527 (1983), discussing the characteristics of a successful reorganization.

spectives, expository models of chapter 11 of the Bankruptcy Code ("Code"). Prominent among these efforts has been the work of a group of scholars, led by Douglas Baird, Thomas Jackson, and Robert Scott, who view the Code as embodying a hypothetical "creditors' bargain" whose primary purpose, the orderly enforcement of creditor's collection rights against the debtor, is vindicated through the Code. To such theorists, the cost and time delays of chapter 11 are difficult to justify. Theorists in this tradition, labeled "free market critics" by at least one commentator, have labored brilliantly to devise market alternatives to the chapter 11 process—ranging from auctions to reliance on capital markets—in an effort to reduce the wastefulness and enhance the "efficiency" of corporate reorganizations. Even within the "free market critics" camp, however, there is the forthright admission that the creditors' bargain model does not explain the endurance of chapter 11 as an alternative to other creditor collection devices, leading one commentator to conclude that chapter 11 must be "efficient" or else it would not survive as a legal institution.

Other scholars, exemplified by Lynn LoPucki and Elizabeth Warren, who are sometimes labeled "traditionalists," prefer to explain chapter 11 as primarily a historical product embodying normative and practical insights that have accreted over years of practical development. They view bankruptcy as "dirty, complex, elastic, and interconnected" and, therefore, reject the possibility of any "unified field

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14. See Jackson, Logic and Limits, supra note 11, at 5 ("The process of [converting ownership of a firm in chapter 11] is costly. Bankruptcy law, at its core, is concerned with reducing the costs of conversion.").
16. See Baird, The Uneasy Case, supra note 11, at 136; see also Baird, Revisiting Auctions, supra note 11, at 647-52 (discussing whether or not the early auction option is appropriate in all circumstances).
17. See Adler, Financial and Political Theories, supra note 11, at 323-33 (advocating the use of "chameleon equity" to be awarded to claimholders in an insolvent corporation as a substitute for the chapter 11 process).
20. Warren, Bankruptcy Policy, supra note 11, at 811.
theory" of chapter 11. Rather, bankruptcy in general, and chapter 11 in particular, are, according to the traditionalists, the means by which the losses from financial distress are allocated "among affected parties according to particular goals, which include—but are not exhausted by—economic efficiency."

There are other, smaller groups of scholars who have applied different philosophical constructs and analytical tools, from game theory to a solicitude for community interests, all in an effort to solve the riddle of why chapter 11 looks the way it does or, indeed, why it exists at all. To date, however, these attempts to explain chapter 11 have failed to explain why, if it is devoid of normative content, society should continue to support the chapter 11 process given its inherently untidy process of negotiation and litigation.

These two broad approaches to chapter 11 suffer from one of two distinct fallacies. The free marketeers view the world, and human action in particular, through the filter of simplifying assumptions that result in abstracting too far from reality. Such critics propose reform or repeal of chapter 11 based upon economic models that themselves are the product of assumptions of perfect knowledge or of the nature of markets that simply do not apply to real-world corporate insolvencies. The resulting proposals—most of them quite clever and well reasoned—have their greatest application in the theorist's simplified world, rather than the world as it really exists.

On the other hand, the traditionalists seemingly throw their hands up at the possibility of ever discerning an overarching principle to explain the structure of chapter 11, given the number of issues raised by corporate insolvency. In viewing the world in all of its complexity, they despair of ever seeing the forest for the trees. Both approaches have yielded scholarship of the highest order and quality, but one is left feeling not entirely satisfied with either. This Article examines chapter 11 through a different lens.

25. See, e.g., Roe, supra note 11, at 559-60 (proposing a corporate reorganization method that depends on efficient market pricing of insolvent corporations).
26. See, e.g., Warren, Bankruptcy Policy, supra note 11, at 777 ("I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing—and sometimes conflicting—values in this distribution.").
Corporate bankruptcy occurs in real time, to institutions made up of human beings who are faced with radical, inescapable uncertainty about the future. All agree that corporations are sometimes "worth" more as a going concern than they would fetch if liquidated, and that such companies are candidates for a corporate reorganization.  

There is another economic approach that, taking heed of these insights, provides a bridge between the free market and traditionalist explanations for the structure, history, and durability of chapter 11. A group of economists known as the "Austrian School" employ an economic method that emphasizes the roles of uncertainty, entrepreneurial discovery, and subjectivism of economic value, largely in contradistinction to the form of neoclassical economics that has achieved primacy in economic thought over the last century.

27. See H.R. Rep. No. 95-595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179 ("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.").

28. Throughout this Article, I will refer this group's economic thinking as "Austrian," "Austrian School," or "Austrian economics." The label "Austrian" is applied to this group in economics literature despite the fact that few of the modern "Austrians" are actually natives of Austria. See Karen I. Vaughn, Austrian Economics in America: The Migration of a Tradition 10 (1998) (noting that by the 1960s, the "Austrian School" was dominated and centered in the United States). I provide a cursory history of Austrian economics infra Part I.A.


30. This is not to say that the neoclassical and Austrian approaches are wholly uncongenial to each other—quite the opposite is true. Rather, Austrian economics
In the Austrian theory of the firm (which is not yet fully articulated), firms (and, indeed, all social institutions) are a response to a lack of centralized knowledge on the part of the individuals who make up the firm. The firm coordinates diffuse knowledge both through planned, hierarchical structures and rules and through spontaneously generated, interstitial rules and customs, best captured in the phrase "corporate culture." A firm's structure and corporate culture are directed to accomplishing the goal of the firm—entrepreneurial discovery. This Article argues that Austrian economics applied to the problem of corporate insolvency provides the explanation for the structure of chapter 11 as it exists today.

Part I introduces the history and economic methodology of the Austrian School. Part II describes the history and structure of the chapter 11 process. Part III suggests an "Austrian" model of chapter 11 which draws evidence from its history and structure. Part IV explores the implications of the approach outlined in part III to several current issues in chapter 11.

I. A Primer on Austrian Economics

To Austrian economists, the individual is the basic unit of economic analysis, a view shared by other economic traditions. Austrians reject schools of thought that depend upon explanations of economic behavior or institutions divorced from human action and actors. Where Austrians part company from other "methodological individualists" supplements neoclassical economics by removing simplifying assumptions regarding knowledge and time from the neoclassicist's model. The happy (to my mind) consequence of the Austrian approach is the sacrifice of the mathematical precision gained through (quite abstruse) modern econometrics for the ability to more fully prescribe and predict the world as it exists.


32. Professor Alan Schwartz has observed that the debate between the free marketers and traditionalists is "characterized by an 'ought/is' mistake." Schwartz, supra note 22, at 1814. That is, the free marketers insist that chapter 11 "ought" to be efficient. "Traditionalists" agree, but respond that they also "want these systems to protect the interests of persons or entities who do not hold current contract-based claims against the insolvent firm." Id. at 1815. Professor Schwartz states that "the appropriate response to an 'ought' claim is an 'ought not' claim, not an 'is' claim." Id. at 1814-15. In this Article, I respond with an "ought not" claim: The central goal of bankruptcy ought not be "efficiency," in the neoclassical sense, but rather preserving and fostering the entrepreneurial process (in the Austrian economic sense) while simultaneously forestalling and preserving creditors' rights. Supporting this "ought not" claim is the task I undertake in this Article.


34. See id.
alists” is in their emphasis on individuals acting according to their subjective perceptions of a world characterized by the real passage of time, ignorance of relevant knowledge, and genuine uncertainty regarding an indeterminate future.

A. History of the Austrian School

Austrian economics has its roots, as does neoclassical economics, in the works of the French Physiocrats and British thinkers such as David Hume, David Ricardo, and Adam Smith. The modern “Austrian School,” however, springs directly from the work of Carl Menger, his students Eugen Böhm-Bawerk and Friedrich von Wieser, and other economists in fin de siècle Vienna. The early Austrian economists developed their ideas in response to classical political economics, and to the dominant German “Historical School.” To the historicists, “social phenomena can be understood only in their entirety,” and thus history is the empirical study of society from which general social laws can be deduced.


38. See Mises, The Historical Setting, supra note 37, at 60.

39. See G. R. Steele, The Economics of Friedrich Hayek 9 (1993). This is not to say that the precepts which undergird Austrian economics sprang wholecloth from Enlightenment or post-Enlightenment sources. Scholars have noted proto-Austrian themes in the works of late scholastic writers, particularly in Spain in the sixteenth century, and in Aristotle’s approach to the methodology of science. See Alejandro A. Chafuen, The Late Scholastics, in The Elgar Companion to Austrian Economics, supra note 1, at 487; Barry Smith, Aristotelianism, Apriorism, Essentialism, in The Elgar Companion to Austrian Economics, supra note 333, at 33.

40. See Boettke, Introduction, supra note 333, at 1.

41. See Samuel Bostaph, The Methodenstreit, in The Elgar Companion to Austrian Economics, supra note 333, at 459-64; Mises, The Historical Setting, supra note 37, at 60.

42. Steele, supra note 39, at 9. The Historical School was prevalent in mid-eighteenth century Germany and is associated with Gustav Schmoller. See id. The empiricism of the Historical School rejected the usefulness of logical deduction and therefore saw little utility in a focus on economics as opposed to history. See id. at 9-10. Ludwig von Mises has stated that the Historical School, through its embrace of state socialism as a result of its historical approach to social sciences, made “Germany safe for the ideas” which led to “aggressive imperialism . . . limitless inflation of the early 1920s, the [command economy] and all the horrors of the Nazi regime . . . .” Mises, The Historical Setting, supra note 37, at 67.
Menger's works emphasized the importance of individual decisionmaking to the study of economics, and distinguished himself from other "marginalists" through his assertion that mathematical modeling was simply insufficient to explain economic phenomena. Proponents of the Historical School greeted Menger's books with ridicule, and labeled them pejoratively as "Austrian."

Menger's disciples continued this tradition with work solidly in the economic mainstream in fields such as monetary theory and choice theory, but with a Mengerian methodological twist. Early Austrian economics was marked from the beginning by a distinct lack of mathematical analysis, recognition of the subjectivism inherent in questions of economic value, and an emphasis on the dynamic nature of markets and economic interactions.

Through the work of the two giants of twentieth century Austrian economics, Ludwig von Mises and Friedrich Hayek, the Austrian


44. This aspect of his work has earned Menger a place beside Leon Walras and William Stanley Jevons as the one of the co-founders of the Marginalist Revolution, which, in turn, is the basis for modern neoclassical economics. See Kirzner, The Meaning of Market Process, supra note 8, at 58.

45. Professor Israel Kirzner of New York University, the dean of the Austrian school, states that:

The central thrust of Menger's book [Principles of Economics] was unmistakable; it was an attempt to rebuild the foundations of economic science in a way which, while retaining the abstract, theoretical character of economics, offered an understanding of value and price which ran sharply counter to classical teachings. For the classical economists value was seen as governed by past resource costs; Menger saw value as expressing judgements concerning future usefulness in meeting consumer wants.

Id.

46. See Mises, The Historical Setting, supra note 37, at 56.

Even if no political and nationalistic prepossessions had disturbed their judgment, they could not help becoming somewhat suspicious of a line of thought which the professors of the universities of the German Reich dubbed specifically Austrian. Never before had any new mode of thinking originated in Austria.... For people who were not familiar with economics, the predicate "Austrian" as applied to a doctrine carried strong overtones of the dark days of the counter-reformation and of Metternich. To an Austrian intellectual, nothing could appear more disastrous than a relapse of his country into the spiritual inanity of the good old days.

Id.

47. Steele, supra note 39, at 10.

48. See Boettke, Introduction, supra note 1, at 1-2.

49. The early Austrians held that the value of a good "is subjectively determined upon the basis of an individual's wants and his knowledge of circumstances and opportunities. Utility [is] not inherent in particular objects, but in the relationships between objects and individuals . . . ." Steele, supra note 39, at 10.

50. See Boettke, Introduction, supra note 1, at 2.

51. Ludwig von Mises was born in 1881 in the city of Lemberg in the Austro-Hungarian empire (now L'vov, Ukraine). See Eamonn Butler, Ludwig von Mises:
Fountainhead of the Modern Microeconomics Revolution 7 (1988). He studied at the University of Vienna where he received a doctorate in law and economics. See id. at 8. His reading of Menger, who was then near the end of his career at the University, influenced his decision to become an economist. See id. Through a long career as a civil servant, scholar, and professor, first in Vienna, then Switzerland, and eventually the United States, Mises was a prolific writer and popular teacher. See id. at 8-11. In his magnum opus, Human Action, he sought to develop the notion of a “science . . . of human action,” of which economics was only a part. Ludwig von Mises, Human Action: A Treatise on Economics 2 (1949) [hereinafter Mises, Human Action]. Mises believed that the nature of human action could be deduced from simple axioms regarding people's behavior and that the influence of “time, uncertainty, and speculation in economic actions,” were factors largely ignored in mainstream, mathematical models based upon simplifying assumptions. Butler, supra, at 16. Mises died in 1973, “the undisputed doyen of the Austrian School of economics.” Id. at 11. Mises works remain influential today. His works include: Ludwig von Mises, Epistemological Problems of Economics (1933) (George Reisman trans., 1960) (exploring the errors implied in the doctrines that reject economic theory); Ludwig von Mises, Nation, State, and Economy (1919) (Leland B. Yeager trans., 1983) (pointing to historical factors in the development of a nation's economics); Ludwig von Mises, Socialism: An Economic and Sociological Analysis (1922) (J. Kahane trans., 1951) (examining the problems of the socialist construction of society with the aid of sociological and economic theory); Ludwig von Mises, The Theory of Money and Credit (1912) (H.E. Batson trans., 1935) (discussing the economic theory underpinning money and credit).

52. Friedrich August von Hayek was born in Vienna in 1899. See Steele, supra note 39, at 3. He received a law degree from the University of Vienna in 1921, despite having spent most of his time reading psychology and economics. See id. He came under the influence of Ludwig von Mises at the University, and worked for him after graduation. See id. at 3-4. During his long life, Hayek lived and worked in the United States, Austria, Germany, and Great Britain (he became a citizen of Great Britain in 1938). See id. at 4-5. Hayek was awarded the Nobel Prize in Economics in 1974. See id. at 5. President Bush awarded him the Medal of Freedom in 1991, shortly before Professor Hayek died in 1992. See Sylvia Nasar, Friedrich von Hayek Dies at 92; An Early Free-Market Economist, N.Y. Times, Mar. 24, 1992, at D22. One commentator sums up Hayek's work as having come “closest to a genuine praxeology, a term . . . which denotes a unified theory of human action.” Id. He believed that “institutions of human society are shaped not by the application of rational intellectual design, but through a natural and spontaneous evolution.” Id. Hayek was an extremely prolific writer. His works include: Friedrich A. Hayek, The Constitution of Liberty (1960) [hereinafter Hayek, Constitution] (stating the criteria by which particular measures must be judged in order to fit into a regime of freedom); Friedrich A. Hayek, The Counter-Revolution of Science (1952) [hereinafter Hayek, Counter-Revolution] (discussing general issues of the study of society and the counter-revolution of science); Friedrich A. Hayek, The Fatal Conceit: The Errors of Socialism (W.W. Bartley III ed., 1988) (examining the development of the differing moralities of socialism and market order); Friedrich A. Hayek, Individualism and Economic Order (1948) [hereinafter Hayek, Individualism] (containing a variety of essays that range from discussions of moral philosophy to problems of economic theory and policy); Friedrich A. Hayek, Law, Legislation and Liberty: The Political Order of a Free People (1979) (describing various means for both avoiding a totalitarian regime and preserving a “democratic” form of government); Friedrich A. Hayek, Law, Legislation and Liberty: The Mirage of Social Justice (1976) (arguing that the scholarly concept of “social justice” does not exist); Friedrich A. Hayek, Law, Legislation and Liberty: Rules and Order (1973) [hereinafter Hayek, Law, Legislation and Liberty] (discussing a transformation of liberal democratic institutions into totalitarian systems); Friedrich A. Hayek, New Studies in Philosophy, Politics, Economics, and the History of Ideas (1978) [hereinafter Hayek,
school diverged, though never completely, from neoclassical economics. Beginning in the 1920s and continuing for several decades, first Mises and then Hayek applied their prodigious energies to unveiling the fallacies behind centralized planning, which so thoroughly captured the imaginations of intellectuals in this century. The debate over the viability of socialism revealed the previously obscured fault lines between neoclassical economics and the Austrian School.

The Austrians perceived that neoclassical economics, with its emphasis on static equilibrium states, ignored the role of discovery, innovation, diffusion of knowledge, and the passage of time. Austrian writings repeatedly emphasized the critical insight that real markets are dynamic, and thus, a detailed study of market processes was more fruitful than mathematical models based upon unrealistic simplifying assumptions and generalizations.

From the 1940s through the 1970s, Austrian economics fell into decline, and many of its sympathizers worked within the neoclassical mainstream supplementing their work with Austrian insights. As many academic economists embraced socialism during those years, Mises and Hayek fled continental Europe for the United States and England, respectively, and were left to tend the flame of Austrian

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New Studies] (containing a collection of essays dealing with problems of philosophy, politics, and economics); Friedrich A. Hayek, Studies in Philosophy, Politics and Economics (1967) (same); Friedrich A. Hayek, The Road to Serfdom (1944) [hereinafter Hayek, Road to Serfdom] (discussing flaws in socialist attitudes toward political systems); Friedrich A. Hayek, The Sensory Order: An Inquiry into the Foundations of Theoretical Psychology (1952) (using accepted psychological assumptions to explain the central problem of the nature of mental phenomena); Friedrich A. Hayek, The Use of Knowledge in Society, in Hayek, Individualism, supra, at 77 [hereinafter Hayek, Use of Knowledge] (discussing the problems that ought to be solved by a rational economic order). For a complete bibliography of Hayek’s works through 1976, see Fritz Machlup, Hayek's Contribution to Economics, in Essays on Hayek 13, 51-59 (Fritz Machlup ed., 1976).

53. Other “Austrian” economists who have made significant contributions in this century include Israel Kirzner, Murray Rothbard, and Ludwig Lachman. See Boettke, Introduction, supra note 1, at 2-3. Twentieth century economists who would not necessarily identify themselves as “Austrians” but nevertheless were influenced by Austrian economic methodology include Gottfried Haberler, Fritz Machlup, Oskar Morgenstern, Lionel Robbins, Joseph Schumpeter, and others. See id. at 2.

54. See Vaughn, supra note 28, at 7.

55. See id.

56. See id.

57. See id.

58. See id. at 8. Professor Vaughn cites Gottfried Haberler, Fritz Machlup, Oskar Morgenstern, and Joseph Schumpeter as prominent Austrian economists who emigrated from Austria during the 1920s and 1930s and “carried on inquiry into Austrian themes using accepted neoclassical language and techniques.” Id. Mises and, perhaps, Hayek did not “assimilate” into the neoclassical mainstream and thus “existed on the sidelines of academia, marking time and despising for the future” because of the “perceived triumph” of socialism and the concomitant failure of its Austrian critique. Id.
ideas, though in what one commentator labels "despair" in their "diaspora."

Though glimmers of a renaissance of Austrian economics were apparent from the early 1960s, it was not until the 1970s that Austrian economics began its true resurgence. Hayek won the Nobel Prize for economics in 1974, an event that set the stage for the Austrian revival. The subsequent work of Austrian economists, such as Israel Kirzner on entrepreneurship and Ludwig Lachmann on institutional economics...

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61. Some commentators date the “Austrian revival” to a conference in 1974 in South Royalton, Vermont, sponsored by the Institute for Humane Studies. See Vaughn, supra note 28, at 104. United by their interest in Hayek and Mises, the participants included such important modern Austrian economists as Israel Kirzner, Ludwig Lachman, and Murray Rothbard. See id. at 104-05. Milton Friedman attended the conference and caused a stir by stating that “there is no such thing as Austrian economics—only good economics, and bad economics.” Id. at 105.

62. See id. at 104.


tions, attracted enough interest to lead to the establishment of Ph.D. programs in Austrian economics at New York University and George Mason University, a Ludwig von Mises Institute at Auburn University, and numerous course offerings in Austrian economics in colleges and universities throughout the United States. Interest in Austrian economic analysis today is burgeoning, leading one legal scholar optimistically to predict "a Kuhnian revolution in economic theory where the Austrian approach will henceforth share equal billing with the neoclassical paradigm" both in economic analysis and its application to law.

With such a long and varied historical pedigree, it is not surprising that Austrian economists are not homogenous in thought or method. They do, however, share certain principles that distinguish them from the adherents of other economic methodologies, beginning with their view of the role of time and uncertainty in economics.

B. Real Time and Uncertainty

Perhaps the most significant difference between neoclassical economic models and those of the Austrian School is their respective treatment of time and the consequences of its passage. Neoclassical models view time as another resource to be allocated, just as land may

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65. See Crespi, supra note 29, at 321 n.29.
66. Professor Israel Kirzner has identified several different understandings of the term "Austrian School" which are current, at least in the economics profession, today: (1) Purely Historical—the followers of Menger and their work has been partially absorbed and partially eclipsed by modern neoclassical economics; (2) Limited to Capital and Interest Theory—the Austrian School in this area is associated with the work of Böhm-Bawerk in the field, and has little reference to Mengerian subjectivism; (3) Libertarian Politics—due largely to the work of Murray Rothbard in political philosophy, many economists confuse Austrian economics with a libertarian political philosophy; (4) Menger, Mises, and Hayek—to still other economists, the Austrian School represents a revival of interest in the work of the three titans of Austrian economics, including the ideas described in this paper; (5) Emphasis on Radical Uncertainty—a subset of (4), some economists associate the Austrian School with the radical subjectivity and emphasis on uncertainty in the work of, among others, Ludwig Lachmann. See Kirzner, The Meaning of Market Process, supra note 8, at 66-69. I hereinafter use the term “Austrian School” in the sense of (4) and, to some extent, (5).

67. Crespi, supra note 29, at 322 (footnote omitted) (citing Thomas Kuhn, The Structure of Scientific Revolution (3d ed. 1970)).
68. Professor Gerard P. O’Driscoll, Jr. and Mario J. Rizzo are, to my knowledge, the economists that have most fully explored the differences between the Austrian view of time—which they call “real time”—and the neoclassical conception—which they term static or “Newtonian” time. See Gerald P. O’Driscoll, Jr. & Mario J. Rizzo, The Economics of Time and Ignorance 52-70 (1985).
be allocated among different uses. They derive outcomes purely from initial conditions, thus rendering time empty of independent content. Neoclassical economics must deny any independent significance to time's passage because each point in time lacks any specific content. Thus, time is analogous to a line in geometry—each point represents merely a position in space, but is devoid of any content beyond its position. Taking the neoclassical view of time seriously means that "time can elapse without anything happening." As a result, neoclassical economists have no trouble reconciling their static concept of time with economic models that assume perfect predictability in human affairs.

Austrian economists do not accept the neoclassical view. The Austrian concept of "real" or "subjective" time recognizes a "dynamic" conception of time. Real time is linked to both the past, in the form of memory, and to the future, in the form of expectation. Real time is irreversible in the sense that once the present becomes the past it cannot be revisited. An individual changes from one moment to another because with each moment the individual gains experience that changes him from who he was a moment ago. As the individual gains experience through time, his subjective perceptions of the world and plans for the future change as well. The revision of perceptions and plans through past memory and experience leads to increased knowledge of the world in the present.

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69. See id. at 2-3.
70. See Vaughn, supra note 28, at 135.
71. See O'Driscoll & Rizzo, supra note 68, at 54.
72. See id.
73. See id.
74. See id. at 3.
75. See id. at 1-4.
76. See id. at 2.
77. O'Driscoll and Rizzo illustrate their concept of time with the example of how we experience a melody:

Hearing only one note of a melody, for example, is insufficient to capture the experience of music. This is because our perception involves memory of the just-elapsed phases (or notes) and anticipation of those yet to come. The actual experience is thus more than a mathematical instant; it is impossible to subdivide continuously a piece of music without fundamentally altering or negating the experience. The dynamic structure of real time consists, then, of two aspects: memory and expectation. On this view, the present is in principle linked with other periods through the perceptions of the individual.

Real time thus implies the very linkages from which Newtonian time abstracts.

Id. at 60 (citation omitted).
78. O'Driscoll and Rizzo state:

[All economic processes must involve the transmission and growth of knowledge. . . . [C]ompetition is no longer merely the name given to a certain equilibrium state. Instead, . . . the process of competition is literally a discovery procedure. The growth of knowledge is the endogenous force that endlessly propels the system.
Learning, in the sense of acquiring new knowledge, is thus a dynamic and inevitable result of the passage of real time. If learning is a consequence of real time, then the future cannot be determined mechanically—it is open-ended, indeterminate. An indeterminate future means that uncertainty is inherent and insuperable; humans constantly face genuine uncertainty regarding the future, and this uncertainty inheres in a world of real time. The acting person cannot predict his own future knowledge, nor can one economic actor perfectly coordinate his plans with those of another. This insight has profound implications for the study of the market. “[T]he emergence of new ideas in business—new products, new technologies . . . and new ventures—can never be anticipated precisely in advance. . . . If entrepreneurs could predict their future discoveries, they would become present discoveries, and the growth of their knowledge would thus come to an end.”

Uncertainty about the future and about the plans of others means that inevitably individuals often will be mistaken when they act. Imperfect knowledge about the world means, inevitably, that people will err.

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79. O'Driscoll and Rizzo state:
A world in which there is autonomous or creative decision-making is one in which the future is not merely unknown, but unknowable. There is nothing in the present state of the world that enables us to predict the future state because the latter is underdetermined by the former. (This, of course, does not preclude the analyst from, ex post, making the once-future intelligible on the basis of what happened in the past.) Subjectivism and action under uncertainty are thus inseparable ideas.

O'Driscoll & Rizzo, supra note 68, at 2.

80. See id. at 66-67.
81. See Harper, supra note 7, at 108-09.
82. Id. at 109.
83. Professor Cordato summarizes the importance of the notion of real time as follows:
The essence of time passage is change; change in preferences, change in technology, change in population, etc. The significance of these changes for economics is that they are either the product of, or they lead to, changes in human knowledge. Furthermore, the process by which knowledge changes is an imperfect one of trial and error, which itself, is time dependent. By implication, then, at any point in time some actions will be taken that are based on erroneous information. In other words, people will make plans that are inconsistent with the goals that they are pursuing. In a market setting, such actions are penalized with losses. These losses provide incentives to discard erroneous information and reassess and redesign plans in hopes
C. Subjectivism

Another pillar in the thought of Austrian economists from Menger to the present is a belief in “dynamic subjectivism.”\textsuperscript{84} The purpose of social sciences is to account for the “unintended and unforeseen patterns of results that evolve from . . . human interactions.”\textsuperscript{85} Economists must seek to understand the subjective meaning that human beings attach to their actions in the world and the things around them,\textsuperscript{86} taking into account the incomplete, subjective knowledge and perceptions of human actors in any given situation. Subjectivists posit that human action is not determined solely by external facts.\textsuperscript{87} There is room within the study of human action for individual creativity and choice founded upon subjective perceptions, beliefs, and knowledge.\textsuperscript{88}

Neoclassical mathematical models, on the other hand, recognize the subjectivity of human preferences, but nothing else, thus reducing economics to the study of “constrained [utility] maximization.”\textsuperscript{89} Such an exercise is bound to fail wholly or in part as a model with expository power for the real world of human action. Neoclassical economic “[a]gents do not make real choices, they exercise no imagination and their maxima are simply functional implications of objective data.”\textsuperscript{90}

that future activity will be based on accurate information and be rewarded by profits. This is an ongoing process of plan formulation and revision in light of new information. Knowledge is never perfected. As problems are fixed new ones are revealed by the continuous generation and flow of new information.

Cordato, \textit{Time Passage}, supra note 29, at 277.

84. “The essential premise of dynamic subjectivism is that decisions are not the determinate result of clearly specifiable causes.” O’Driscoll & Rizzo, supra note 68, at 24 (citation omitted).

85. Horwitz, supra note 2, at 17.

86. \textit{See id.} (quoting Hayek, \textit{Counter-Revolution}, supra note 52, at 44, 53) (“So far as human actions are concerned the things \textit{are} what the acting people think they are . . . [and] unless we can understand what the acting people mean by their actions any attempt to explain them . . . is bound to fail.”).

87. \textit{See O’Driscoll & Rizzo, supra} note 68, at 1.

88. \textit{See id.}

89. Vaughn, supra note 28, at 134; \textit{see O’Driscoll & Rizzo, supra} note 68, at 22-23.

90. Horwitz, supra note 2, at 20. Professor Harper states that:

Neoclassical maximisers do not face genuine problems, because the situations that they encounter exclude all elements of surprise and novelty. Even in game theory, a decision is specified for every imaginable situation: genuine surprises in the course of the game are excluded. Economic actors in neoclassical theory do not face problems in deciding what to do (i.e. the choice of ends) and how to do it (i.e. the choice of means). They are able to react to their situations instantaneously, and their responses are in general immune from the hazards of error . . . . The rationality postulate (in the narrow sense of consistency of the agent’s behaviour with the relevant given ranking of ends) is sufficient to explain pure economising activity. Neither entrepreneurial alertness nor imagination is required.

\ldots

“\ldots Learning in the usual neoclassical analysis is a universal process that is exogenously given and thus unexplained \ldots”
Using such a model, economic decision-making essentially becomes a classical physics\textsuperscript{91} problem. Given certain objectively defined initial conditions, such as full relevant knowledge on the part of all actors and zero transaction costs, human choice is reduced to a mathematical equation from which the economist can derive the “resulting equilibrium outcome for each actor and for the market as a whole.”\textsuperscript{92}

In contrast, Austrian economists in the tradition of Ludwig von Mises approach economics as the study of subjective human action that

is a far broader concept than that of [neoclassical] economising; while the allocation of scarce means among multiple competing ends may be an example of human action, human action need not be allocative at all. “Human action is purposeful behavior.” What acting man seeks to do is “to substitute a more satisfactory state of affairs for a less satisfactory.” Nothing in these formulations confines them to the calculative allocation of scarce means with respect to competing goals.

... The essential element in action is goal pursuit, not maximization, not allocative efficiency, or anything else. ... Subjectivism in the analysis of Misesian human action includes the insight that any ends-means framework relevant to a human action has itself been actively chosen in the course of that very action—and that that choice expresses and reflects that agent’s dreams, aspirations and imagination, his expectations and his knowledge, his hunches and his biases.\textsuperscript{93}

The implication of the Misesian view is that any model of economic actors as mechanistic allocators of economic resources is too simplistic.\textsuperscript{94}

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Harper, supra note 7, at 84-85 (quoting L.A. Boland, Methodology for a New Microeconomics: The Critical Foundations 157 (1986)).

91. “[N]eoclassical economics[]” has in the past often been praised and damned by being held up to the standards of physics. ... [T]he progenitors of neoclassical economic theory boldly copied the reigning physical theories [of] the 1870s ... mostly term for term and symbol for symbol, and said so.” Philip Mirowski, More Heat than Light: Economics as a Social Physics: Physics as Nature’s Economics 3 (1989).

92. Crespi, supra note 29, at 326.


94. Mises stated that an economist interested in a theory of human action more meaningful than a mathematical construct such as the equilibrium reached if all “further changes in data were to cease,” will

show[] how the activities of enterprising men, the promoters and speculators, eager to profit from discrepancies in the price structure, tend toward eradicating such discrepancies and thereby also toward blotting out the sources of entrepreneurial profit and loss. He shows how this process would finally result in the establishment of the evenly rotating economy. This is the task of economic theory. The mathematical description of various states of equilibrium is mere play. The problem is the analysis of the market process. Mises, Human Action, supra note 51, at 352-53. It should be noted that Mises’s view that the market process would tend toward an “evenly rotating economy,” id. at 245,
Building upon Mises's work, Friedrich von Hayek stressed the role of knowledge in the market. Hayek is famous for stating:

The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The economic problem of society is thus not merely a problem of how to allocate "given" resources—if "given" is taken to mean given to a single mind which deliberately solves the problem set by these "data." It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality.95

The myriad and profound implications96 of Hayek’s subjectivist framing of the “economic problem” include the recognition that the market is a dynamic process geared to learning, and that the role of social institutions is to aid in coordinating dispersed knowledge.97 These themes are explored below.

D. Entrepreneurship and the Market Process

Austrians define ignorance as the “utter unawareness of some aspect of the world germane to choice.”98 If the actor becomes aware of the facts of which he was previously ignorant, it cannot be through a conscious choice on his part, or else he would truly not have been ignorant of the fact, but rather simply blind to the benefits of information of which he was already aware.99 Hayek’s insight that knowledge is diffused widely among individuals in a society means that no one person or institution is or could be the repository of all knowledge. Individuals in the market (and economists at their desks) must come to grips with this inevitable ignorance of economic actors.

An individual’s response to the twin realities of genuine uncertainty regarding the future and his own ignorance of beneficial knowledge is not uncontroversial among Austrian economists, some of whom reject the notion that there is any point toward which the economy naturally tends. See Kirzner, Entrepreneurial Discovery, supra note 63, at 79-82.

95. Hayek, Use of Knowledge, supra note 52, at 77-78.
96. Professor Israel Kirzner opines that “Hayek’s insights . . . pointed to a comprehensive fully . . . subjectivist revolution of understanding in [microeconomics and welfare economics]. That these threatened revolutions somehow never succeeded in dislodging the neoclassical dominance is mute evidence of the very limited extent to which the modern profession has been hospitable to extensions of subjectivism.” Kirzner, The Meaning of Market Process, supra note 8, at 133.
97. See id.
98. Ikeda, supra note 6, at 23. The alternative form of ignorance, of course, is willful ignorance of germane knowledge of which the actor is aware. See id.
99. See id.
action. In the context of economic decisions, Austrians stress that individuals act entrepreneurially; i.e., they are alert to opportunities previously overlooked due to their own or others' ignorance. Entrepreneurs notice, exploit, and eventually correct gaps in the market. The entrepreneur is the key, therefore, to an understanding of the market process and its fruits—innovation and growth of knowledge in society.

Neoclassical economists, on the other hand, emphasize an individual's selection of a course of action with respect to a given means by maximization of his "utility." The neoclassical market, in turn, is the result of the individual decisions of myriad "economizing individuals, each making his decisions with respect to given series of ends and means." The neoclassical economic person has all relevant knowledge concerning the world around him, and a defined means-ends framework. Solving for the optimum result, given that all potential variables are defined by the assumptions, is trivial. It is no wonder that neoclassical economic models have difficulty accounting for the existence and role of entrepreneurs in the market.

Austrian economists reject such determinism in favor of a system that does not constrain the entrepreneur to calculating maximum outcomes within a given ends-means framework. The Austrian entrepreneur acts within the ends-means framework perceived by her, given her uncertainty about the future and her ignorance of at least some potentially relevant knowledge. To complicate matters further, as the entrepreneur makes decisions, alertness to the possibility of new ends and means worth pursuing leads to revision of her plans as well.

100. Mises defines the entrepreneur as an "acting [person] exclusively seen from the aspect of the uncertainty inherent in every action. In using this term, one must never forget that every action is embedded in the flux of time and therefore involves a speculation.... There's many a slip 'twixt cup and lip." Mises, Human Action, supra note 51, at 254.

101. This view of an entrepreneur as alert to previously overlooked opportunities has its roots in the work of Ludwig von Mises. See id. The most prominent Austrian commentator on the theory of entrepreneurship is Professor Israel M. Kirzner of New York University. See, e.g., Kirzner, Competition, supra note 63, at 1 (developing an unorthodox theory of the market and price system); Kirzner, Discovery, supra note 63, at ix (discussing some normative and policy implications of a differing vision of capitalism); Kirzner, The Meaning of Market Process, supra note 8, at ix (arguing that mainstream economic conclusions must be defended by introducing subjectivist Austrian economic insights); Kirzner, Entrepreneurial Discovery, supra note 63, at 60 (setting forth a differing approach on microeconomic theory within Austrian economics). The Austrian entrepreneur should not be confused with the neoclassical one. As Professor Kirzner states: "In standard neoclassical equilibrium theory there is, by its very character, no role for the entrepreneur. In equilibrium [theory] ... there is simply nothing for the entrepreneur to do." Kirzner, Entrepreneurial Discovery, supra note 63, at 69.


103. Kirzner, Competition, supra note 63, at 33.

104. See id. at 36-37.
is important to stress, however, that the Austrian entrepreneur does not act in a purely chaotic world of unlimited choice. Although the entrepreneur acts within her own subjective judgment concerning the universe of possibilities available, those subjective possibilities are always "bounded" by the entrepreneur's rational judgment concerning the "constraints that limit the ways in which market events can follow each other." 

Moreover, entrepreneurs act in a dynamic world where tomorrow will be different from today. As consumer tastes change and as new opportunities are exploited, new entrepreneurial opportunities will arise, which will be noticed by an alert individual who will exploit them ad infinitum. "This ongoing social 'learning' process, and the continual revealing and pursuit of entrepreneurial opportunities, is regarded by Austrians as the central dynamic force underlying the evolution of not only markets, but also of all other social institutions." 

Austrians led by Professor Israel Kirzner believe, therefore, that the market is a process that "provide[s] a systemic set of forces, set in motion by entrepreneurial alertness, which tend to reduce the extent of mutual ignorance. Knowledge is not perfect; but neither is ignorance necessarily invincible." This vision of the entrepreneur led Professor Kirzner to conclude that the Austrian view of the market represents a "middle ground" between the polar extremes of neoclassical economics, with its assumptions of perfect knowledge on the part of market actors, and radical subjectivists, who utterly deny the relevance of models concerning market equilibration. Kirzner's view, "developed from Misesian insights . . . finds entrepreneurship incompatible with the equilibrium state, but compatible with, and indeed essential for, the notion of the equilibration process." Thus, the market never is, and can never be, in a neoclassical equilibrium state; however, the market process provides the context and incentive for

105. Professor Kirzner writes that:
   The world is indeed constantly changing in unpredictable ways. People die, babies are born, tastes change spontaneously. Resource availabilities change over time; technological knowledge may evolve autonomously. But, it would be insisted, the rapidity and unpredictability of these changes is not, in general, so extreme as to frustrate the emergence of powerful and pervasive economic regularities. It is because these changes are frequent enough to ensure perennial disequilibrium that we need to understand the nature of equilibrating forces. It is because of the possibility, at least, of a benign limit to the volatility of these changes that these equilibrating forces do, at least sometimes, manifest themselves as unmistakable economic regularities.

106. Harper, supra note 7, at 102.

107. Crespi, supra note 29, at 328. The stress on market processes distinguishes Austrian economics from the neoclassical use of simplifying assumptions of "stable equilibria and instantaneous adjustment." Id.


109. Id. at 7 (emphasis added).
entrepreneurs to perceive and exploit opportunities in the form of market gaps or disequilibrium.\textsuperscript{110}

Austrian economists have begun to flesh out the implications of Kirznerian entrepreneurship for the market process.\textsuperscript{111} To some commentators, Professor Kirzner’s concept of entrepreneurship as “alertness” emphasizes the “non-rational, intuitive faculties required of an entrepreneur.”\textsuperscript{112} The Kirznerian entrepreneur will notice things that are in her interest to notice, and thus very few hundred-dollar bills reside long on a street in New York City. The Kirznerian conception of entrepreneurship, however, has been criticized for not accounting fully for the potential for learning or true creativity on the part of the entrepreneur.\textsuperscript{113} In the words of one Austrian economist, “[c]hanges in consumer tastes, technological possibilities and resource availabilities are simply known by the alert and astute [Kirznerian] entrepreneur, although this knowledge may not be widely dispersed among other market participants who might find it useful.”\textsuperscript{114} Entrepreneurship is possible because other market participants simply have overlooked information that the alert entrepreneur spots.\textsuperscript{115}

Not entirely satisfied with this model of entrepreneurship, others have sought to understand better how an entrepreneur, faced with uncertainty, espies an opportunity and translates her discovery into a successful venture. Professor David Harper has proposed what he calls a “growth of knowledge”\textsuperscript{116} model of entrepreneurship. Harper

\begin{itemize}
  \item \textsuperscript{110} Professor Harper develops his model from Karl R. Popper's theory of the growth of scientific knowledge, which holds that there is no “infallible method available to us for acquiring knowledge which can guarantee us the truth.” Id. at 4. Specifically, Popper rejects inductive reasoning based upon empirical observation as a method of discerning whether or not a theory is true. See Karl R. Popper, The Logic of Scientific Discovery 27 (1992) (“[N]o matter how many instances of white swans we may have observed, this does not justify the conclusion that \textit{all} swans are white.”). Rather, knowledge grows over time through a dynamic process in which scientific
\end{itemize}
posits that entrepreneurs constantly formulate hypotheses in order to solve problems presented and perceived through the market process. As the entrepreneur's hypotheses are proved false in the market, the entrepreneur reformulates her ideas in a continuous loop of trial and error. The "sophisticated falsificationist entrepreneur" relies on logical reasoning, rational (and unyielding) criticism of her own plans and theories, and a willingness to learn from mistakes. Through this weeding out of error, the entrepreneur gains and creates knowledge, which she then translates into market action.

The entrepreneur engages in this process to sell her goods or services in order to satisfy the wants and needs of consumers. The Harperian entrepreneur's goals, and thus the goals of the market process as well, are to "serve each other, to think how to improve serving each other, to be willing to take risks in the face of uncertainty, and . . . to be willing to commit themselves to . . . [learning]." Entrepreneurs must, therefore, be left alone to engage in the process of learning through mistakes in order that we may find those entrepreneurs who can most satisfy our subjective desires. There is no alternative to leaving markets (and thus entrepreneurs) free from interference because it is impossible to identify "in advance which individuals will conceive the best ideas." If successful, the entrepreneur draws imitators who have observed the positive results of the entrepreneur's actions, and the result is market competition.

hypotheses are tested, falsified, and reformulated. A scientific theory is never certainly true, despite the fact that every experiment to date has shown it to be accurate. For example, Newtonian physics held sway for several hundred years until observational techniques improved to the point that physicists observed physical phenomena that could not be explained adequately. These observations ushered in the era of quantum physics as scientists developed new theories to replace Newtonian theories that were now inadequate. Professor Harper seeks to apply this model of knowledge, which he characterizes as "non-justificationist"—that is, it "divorces knowledge from certainty, proof, and 'hard' facts"—to market processes. Harper, supra note 7, at 4 (citation omitted). The connection between Popper's philosophy of science and entrepreneurial activity is that "[l]ike scientific enterprise, entrepreneurship is . . . essentially . . . a problem-solving activity" which is an "inter-subjective and pluralistic process for generating conjectures, exchanging and promoting ideas and attempting to refute them." Id. at 5.

117. "Like scientists, entrepreneurs are constantly engaged in solving problems which tend to involve much novelty and which are ill-specified. Problems are not avoided, but actively sought as a challenge." Id. at 121.

118. Id. at 317-18.


120. See id. at 236.

121. Id. at 236 (quoting Harper, supra note 7, at 292).

122. See Vaughn, supra note 28, at 156.
E. Human Plans, Social Institutions, and the Austrian Theory of
the Firm

The work of Ludwig Lachmann on a theory of social institutions
supplements the Austrian emphasis on the entrepreneur and dynamic
market process. As an Austrian economist, Lachmann recognized the
importance of subjectivism, uncertainty, and the passage of time. In
his words, "[t]he future is unknowable, but not unimaginable."123
Lachmann believed that human beings respond to uncertainty by for-
multiplying "plans" that represent their best evaluation of the unpredict-
able future.124 In 1944, Lachmann wrote:

A social process consists of a number of mutually interrelated
human actions. To analyse a social process means to explore the
mode of this interrelationship, to dissect the process into actions.
To understand an action means not only to know what it is "for," its
purpose, but also to know the plan behind the action, to reduce "ac-
tion" to "plan". In analyzing a social process we have to start with
the plans of the individuals, for it is their simultaneous attempts to
carry out these plans—which may be inconsistent with each other
and are to that extent bound to fail—which give rise to the process
and determine its pattern.125

To Lachmann, the plan is the first step in purposeful human action,
and thus the starting point for any economic model.126

Moreover, Lachmann asserted that humans seek to "coordinate"
their plans, to the extent that they overlap, through the formation of
institutions that "provide[ ] means of orientation to a large number of
actors. [Social institutions] enable[ ] them to co-ordinate their actions
by means of orientation to a common signpost."127 Institutions are
therefore vital to society:

They enable each of us to rely on the actions of thousands of anony-
mous others about whose individual purposes and plans we can
know nothing. They are nodal points of society, co-ordinating the
actions of millions whom they relieve of the need to acquire and
digest detailed knowledge about others and form detailed expecta-
tions about their future action.128

Thus, the entrepreneur, if necessary, may combine her plan with the
plans of others in order to take advantage of their dispersed knowl-
dedge that the social institution coordinates to the advantage of all. In-
dividuals’ plans "crystallize" spontaneously into institutions which
"are the relics of the pioneering efforts of former generations from

123. Id. at 152 (quoting Lachmann, supra note 64, at 55).
124. See id. at 155.
125. Ludwig Lachmann, Finance Capitalism?, in Lachmann, Expectations and Insti-
tutions, supra note 64, at 107, 118.
126. See id.
128. Id. at 50.
which we are still drawing benefit.”

Lachmann’s insights regarding societal institutions in general are, of course, crucial to the development of an “Austrian” theory of the firm. Despite the efforts of a few scholars, there is a noticeable dearth of information or interest among Austrian economists in the theory of the firm, which is all the more striking because of the extant Lachmannian approach to social institutions. From an Austrian perspective, the mainstream theories of the firm are deficient in several particu-

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129. Id. at 68.

131. In the neoclassical theory of the firm, a manager buys and sells economic inputs and outputs in a spot market in an effort to maximize the profit to the owner. See Oliver Hart, *An Economist’s Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757, 1759 (1989). In principal-agent theory professional managers (the agents) run the corporation on behalf of the owners (the principals). See id. Because the managers have their own agendas, their interests will not be congruent to those of the owners, so the task of the owners are to give their agents the incentives to minimize the conflict between the principals and the agents. See id.

In contrast to the neoclassical tradition stands the “transaction cost” explanation of the firm. In 1937, Professor Ronald Coase wrote his brilliant article, *The Nature of the Firm*, in which he hypothesized that firms are alternatives to the market. Ronald H. Coase, *The Nature of the Firm*, Economica, n.s., 4 (1937), reprinted in Ronald H. Coase, *The Firm, the Market and the Law* 33 (1988). Professor Coase explained that firms arise due to the transaction costs (although he did not use that term) of contracting for resources in the market. See id. at 38-42. The boundary line between contracting through firms and in the market is the point at which the transaction costs of doing so through either institution is equal. See id. at 40. See also Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777, 783-95 (1972) (extending Coase’s theory of the firm by introducing the concepts of team production, asymmetric information, and moral hazard, concluding that successful firms are those that minimalize monitoring costs).

In another landmark paper, Professors Jensen and Meckling proposed the “nexus of contracts” theory of the firm:

The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships. . . . Viewed this way, it makes little or no sense to try to distinguish those things which are “inside” the firm . . . from those things that are “outside” of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.


Finally, the “property rights” theory of the firm focuses on the rights of various firm actors to the physical assets of the firm. Owners of physical assets control their use, which, in turn, gives them leverage in negotiating how to split the profits generated by those assets. See Hart, supra, at 1767-68. The firm structure enables the parties to
lars. First, economic decision-makers in mainstream theories are presented with a series of contractual alternatives from which they choose. The economic decision-maker is faced with the choice between whether to engage in market contracting transactions or form a firm or some other entity. The decision-makers's choice is driven by a given set of factors. The only choice available to the decision-maker in these models is the discretion to choose the optimum contracting mechanism, a choice that is obvious given that all factors impacting the decision are stipulated. In other words, there is no room for entrepreneurship, and it is no surprise that mainstream theories of the firm do not account satisfactorily for entrepreneurial activity.

Second, there is no market process in the mainstream accounts. The principal of the firm hires an agent to carry out the principal's wishes with regard to production, subject only to the agent's tendency to be risk-averse. The only interesting question is whether the risk-averse agent will act in the interest of the principal, given the risks and rewards of doing so, or whether the agent will act in his own self-interest. The principal's main task is figuring out how to optimize the tradeoff between the principal's desired outcome and the risk aversion of the agent. In the mainstream models, the principal is able to design the optimum structure to solve the contracting problems, and this solution continues to be optimal over time.

Third, mainstream models assume strong knowledge on the part of different economic actors. Although information may be asymmetrically distributed among individual economic decision-makers, mainstream models still assume that other individuals, for example, the principal of the firm, have perfect knowledge of the alternatives open to their agents. Thus, the principal of a firm can never be genuinely surprised by the results of her agents' actions, nor can there be any true discovery of market opportunities in the sense used by Austrian economists.

These critiques open the door to the development of a unique Austrian theory of the firm, which has been a focus in the work of Professor Nicolai Foss and his collaborators. Professor Foss applies the general Austrian critique of neoclassical economics to the firm—under determine who owns particular assets and the extent of those property rights. See id. at 1771. In this Article, I adopt Professor Foss's habit of referring to these theories under the general rubric of "mainstream theories" of the firm.

132. See Foss, Theory of the Firm, supra note 130, at 182.
133. See id.
134. See id.
135. See id.
136. See id.
137. See id.
138. See id.
139. See id.
140. See id. at 183.
realistic assumptions regarding the knowledge of economic actors, a failure to take account of real time and therefore of market processes, and, finally, a failure to account for genuine uncertainty and the ability of economic actors to learn and generate knowledge through entrepreneurship.  

Firms are examples of what Friedrich Hayek labeled a planned (as distinguished from a spontaneous) order. Building upon Hayek’s insights on the nature of knowledge in society, Austrian economists describe institutions, such as firms, as pools of idiosyncratic, local knowledge. Employing this knowledge, firms facilitate spontaneous learning on a local (as opposed to global or market) level. Therefore, firms have a dual nature—they are planned orders that permit a spontaneous, unplanned procedure “which both makes the utilization of more facts possible . . . and which provides the incentive for constant discovery of new facts which improve adaptation to the ever-changing circumstances of the world in which we live.” Knowledge in firms is coordinated through diktat by decision-makers or, usually unconsciously, by “routines” or corporate culture. Routines that permit the firm to discover knowledge are selected over those that do not.

Professor Foss has explored in detail the types of knowledge that inhere in firms. Distributed knowledge resides in the firm’s agents as a group, but which no one individual agent has in toto. Foss cites the example of General Motors (“GM”)—the individuals who make up GM know as a group how to make automobiles, but no one individual possesses the full knowledge necessary to make them. GM must devise ways to coordinate the information found in the pool of its employees in order to successfully manufacture a car. To Foss, the fundamental purpose of the firm is to provide a structure that will

\[141.\] See id. at 186.  
\[142.\] See Hayek, I Law, Legislation and Liberty, supra note 52, at 49-50; see Foss, The Austrian School, supra note 31, at 157 (citing Hayek, I Law, Legislation and Liberty, supra note 52, at 48-52).  
\[143.\] See Foss, Theory of the Firm, supra note 130, at 177.  
\[145.\] Friedrich A. Hayek, The New Confusion About “Planning”, in Hayek, New Studies, supra note 52, at 236. Though Hayek was speaking in terms of the market, his insight applies equally to the spontaneous generation of knowledge within the firm.  
\[146.\] See Foss, The Austrian School, supra note 31, at 173; see also Foss, Theory of the Firm, supra note 130, at 186 (“[F]irms are indeed planned orders in the Hayekian sense. However, . . . social institutions do not just fall neatly into two separate categories: spontaneous and planned orders. . . . [F]irms contain ‘grown’ elements, such as what goes under the name of ‘corporate culture.’”).  
\[147.\] Foss, Theory of the Firm, supra note 130, at 190.  
\[148.\] See id. at 189.  
\[149.\] See id.
coordinate the distributed knowledge of the firm's actors so that their plans dovetail in an effort to accomplish the overarching plan of the firm. Thus, it is the more basic coordination problem of making activities, individual efforts, learning processes, strategies, and so on mesh that is highlighted, rather than the logically secondary problem of, for example, controlling and influencing the level of efforts once everything is in place.

Firms solve this coordination problem in several ways. For example, corporate routines or culture permit the firm to coordinate distributed knowledge without constantly having to "reinvent the wheel." These routines themselves evolve over time, and are thus an example of Hayekian "spontaneous order" within the firm. A second coordinating solution is found in the actions of individuals whom Foss labels "intrapreneurs," who act as Austrian-style entrepreneurs within the firm to improve its method of coordinating knowledge and plans. A third example is management acting by command to ensure that the plans of one division of the firm are coordinated with those of the other.

The Austrian firm thus provides a knowledge-coordinating structure geared to facilitating local discovery procedures through which firm actors engage in entrepreneurial activity in furtherance of the firm's overall business strategy. Professor Harper calls a firm's business plan its "entrepreneurial research programme" which itself is subject to formulation, testing, refutation, and reformulation through the market process. Thus, it is no exaggeration to observe that the Austrian theory of the firm reserves a central role for the entrepreneur and entrepreneurial action at all levels of the firm. This model is consistent with Mises's view that the entrepreneur, not the manager, is the heart of the corporation and the key to its success.

As the foregoing introduction indicates, Austrian economics is indeed a middle ground between neoclassical economics and ultra-radical subjectivists. Subjectivism taken too far denies the possibility of any predictions or models of the real world, and thus rejects the possi-

150. Professor Foss writes: "Rather than transforming noncooperative behavior in potential prisoners dilemma games to cooperative behavior, the role of firms ... is to provide an institutional setting that solves coordination type games. ... Or, translated into the terminology that has been employed here, it is a matter of making distributed knowledge mesh." Id. at 191.
151. Id.
152. See id. at 192-93.
153. See id. at 191.
154. See id. at 192.
155. "Corporate 'intrapreneurs' may act in a basically Kirznerian way by demonstrating alertness to opportunities for integrating hitherto dispersed knowledge." Id. at 192.
156. Professor Foss used these examples in his work. See id. at 191-92.
158. See Mises, Human Action, supra note 51, at 703-04.
bility of elucidating social phenomena through human reason. In short, it denies the possibility of a science of human action.

On the other hand, neoclassicists employ assumptions that enable them to explain certain aspects of the world, but those models cannot be reliably used in all circumstances because they abstract too far from reality. I believe this latter point accounts for the inability of traditional law and economics scholarship to provide a justification for the chapter 11 process.

The Austrian approach to economics not only explains the structure of chapter 11, but also dictates that a process such as chapter 11 is the only alternative if the goal is to ensure that viable "going concerns" will remain in business once they emerge from bankruptcy. I discuss these points further in part IV of this Article, but first, a brief introduction to the history and structure of chapter 11 provides the necessary context for discussion.

II. HISTORY AND STRUCTURE OF THE CORPORATE REORGANIZATION PROCESS

I will now turn to the subject at hand—chapter 11 of the Code. This part examines the history and structure of the corporate reorganization process, not of the Code in general. The emphasis on process obviously is relevant to the Austrian economic approach described above.¹⁵⁹ My intent is to provide the context necessary to reveal the exegetical power of the Austrian economic approach to the search for a satisfactory "explanation" for chapter 11.

A. The Historical Development of Chapter 11

Chapter 11 is the result of a long process of evolution in commercial affairs. Scholars have sifted through the historical record and have largely illuminated from whence bankruptcy law sprung, but their efforts have not discerned conclusively the reasons chapter 11 developed as it did.¹⁶⁰ Though scholars generally trace the antecedents of

¹⁵⁹. See supra notes 37-67 and accompanying text.
modern bankruptcy law to ancient Rome, the direct forebear of American bankruptcy law was the English law of creditors’ remedies. In its earliest forms, English law sanctioned harsh punitive measures against defaulting debtors. The first English bankruptcy laws, passed in 1542 and 1570, were characteristic of bankruptcy law as it existed for the next several hundred years. These early English statutes were exclusively creditors’ remedies. There was no discharge of debts. Bankruptcy could not be initiated voluntarily by the debtor—all cases were involuntary and were commenced by creditors upon the commission of an “act of bankruptcy” by the debtor. Any act that heightened a creditor’s unease about the prospects for repayment of a debt was sufficient basis for beginning a bankruptcy case against a debtor. The debtor’s assets were assembled and sold, and creditors shared the proceeds on a pro rata basis. The debtor remained liable for any shortfall. Bankruptcy law applied only to merchant debtors.

A critically important development in English law was the introduction in 1705 of the discharge of debts, though its genesis actually may have been in the mid-seventeenth century. Professor John McCoid has meticulously traced the events leading up to the introduction of the discharge in English law, and has concluded that it signaled a shift in bankruptcy law from a collection device to a form of the common law remedy of “creditors’ composition.” In a “creditors’ composition,” the debtor and his creditors voluntarily agree to a repayment plan whereby creditors generally receive less than full pay-


161. See Countryman, supra note 160, at 226. “In Rome, creditors were apparently authorized to carve up the body of the debtor, although scholars debate the extent to which the letter of that law was actually enforced.” Tabb, The History of Bankruptcy Laws, supra note 160, at 7.

162. See Tabb, The History of Bankruptcy Laws, supra note 160, at 7 (citing Statute of Merchants, 13 Edw. 1, stat. 3 (1285); Statute of Acton Burnel, 11 Edw. 1 (1283); Statute of Westminster II, 13 Edw. 1, stat. 1, chs. 11, 18 & 45 (1285)).

163. See id.

164. These statutes were 34 & 35 Hen. 8, ch. 4 (1542-43) & 13 Eliz., ch. 7 (1570), passed during the reigns of Henry VIII and Elizabeth I, respectively.


166. The foregoing discussion of early English and American bankruptcy law is drawn from Professor Tabb’s excellent summary. See id. at 7-23.


168. See McCoid, Discharge, supra note 160, at 181-85. Indeed, the English author Daniel Defoe, perhaps the first celebrity debtor, was an earlier and eloquent proponent of the discharge. See id. at 169-73. Defoe, however, seems not to have invented the idea, and its precise origin remains unclear. See id. at 179-81.

169. See id. at 179-85.
ment of their claims against the debtor.  

Professor McCoid asserts that the purpose of the discharge was to buttress the statutory creditors' composition by ensuring an orderly repayment of creditors that was binding on dissenters, thus alleviating the major problem with the common law remedy—holdout creditors. The statutory approach notably did not displace the consensual bargain model with a set of statutory rules; rather, the law sought to give the parties flexibility in arriving at the "composition agreement" within general legal rules which preserved baseline rights of creditors. Importantly, this


171. See McCoid, Discharge, supra note 160, at 183.

172. The common law version had limited utility in the face of holdout creditors, reflecting, perhaps, the fact that it was born in an era when debtors had few creditors, debtors were considered quasi-criminals, and the holdout problem was minimal. As commerce expanded and holdouts became problematic in attempting creditors' compositions, the introduction of the bankruptcy discharge makes sense as a statutory guarantor of a successful workout agreement. Indeed, the powerful "creditors' bargain" model reinforces Professor McCoid's historical argument in an important sense. The creditors' bargain theory asserts that the Code is structured to vindicate the expectations of creditors who hypothetically bargain \textit{ex ante} regarding the distribution of the debtor's property in a subsequent bankruptcy case. See generally Jackson, Logic and Limits, supra note 11, at 214-16 (discussing the underlying justification for the bargaining process). The historical development of bankruptcy law in a way that reflects the agreement of creditors in a hypothetical \textit{ex ante} bargain represents a Lachmannian crystallization into law of the bargain upon which creditors would insist in a common law composition agreement. Rather than sanction bargaining over a plan for repayment of creditors in the typical chapter 7 liquidation, bankruptcy law reduces to statute the spontaneously generated routines of creditors under workout agreements, thereby saving creditors the costs of bargaining with the debtor and among themselves in every case.

173. Professor McCoid's analysis is quite illuminating:

One virtue of the statutory approach is that it avoids the defects of the consensual scheme. At common law, no creditor was bound without assenting to a composition; and, the terms of the agreement necessarily were the subject of negotiation among the debtor and his creditors. Holdouts or disagreements about the appropriate terms could prevent a consensual arrangement. Statutory composition avoids both of these pitfalls. Nonassenting creditors can be bound by a settlement the terms of which are fixed. On the other hand, the principal strength of consensual composition was its flexibility, an attribute hard to achieve by legislation. The parties to an agreement could specify whatever terms they chose. Thus, another virtue of the 1706 experiment was that it did not totally replace bargain with rule. It allowed the two to coexist so that the advantages of both forms of composition became available. Doubtless, any composition agreement had to be formed against the background of the alternative rule, but the parties remained free to strike a different accord when they believed circumstances warranted it.

McCoid, Discharge, supra note 160, at 184. Among Austrian economists, Friedrich Hayek in particular studied law as an institution from an Austrian perspective. See Hayek, Constitution, supra note 52, at viii. Hayek stressed the importance of general rules that were rigorously enforced as the best way of structuring a legal system, precisely the approach to bankruptcy law that Professor McCoid identifies. See id. at 148-61.
The framers of the Constitution included the Bankruptcy Clause among the enumerated powers of Congress because of the perceived interplay between the congressional power to regulate commerce and the potential interstate nature of debt collection. Congress chose to exercise its power under the Bankruptcy Clause only sporadically for the first hundred years of the Constitution’s history. Though Congress passed bankruptcy laws (largely in response to financial crises) in 1800, 1841, and 1867, it was not until the Bankruptcy Act of 1898 that Congress passed a comprehensive and enduring statute. Innovations associated with these early statutes include the extension of bankruptcy relief to non-merchant debtors, the authorization of voluntary bankruptcy cases, and the provision of exemptions for debtors. Critically for the history of chapter 11, the 1874 bankruptcy law formally introduced the concept of a “composition agreement” which permitted the debtor to receive a discharge and keep his property in exchange for agreeing to pay off a certain percentage of debts over time.

A second key development in the late nineteenth century was the railroad equity receivership. It is difficult to comprehend from our present vantage point the influence and importance of railroads at the end of the last century. In an era of robust competition lacking a federal bankruptcy law, the inevitable insolvencies of railroads presented legal and social problems that simply had to be solved. Equity courts adapted the equity receivership procedure to fill the gap. In such receiverships, the court would appoint a trustee, generally the

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174. See id. at 176-92.
175. “Congress shall have the power . . . to establish uniform Laws on the subject of Bankruptcies.” U.S. Const. art. I, § 8, cl. 4.
176. See The Federalist No. 41 (James Madison) (“The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie, or be removed into different States . . . .”).
180. See id. at 21.
181. See Adams, supra note 160, at 584-87.
182. Adams describes the necessity of bankruptcy laws for railroads:
Railroads possessed enormous assets, rights of way over narrow strips of land, and hundreds or even thousands of miles of iron rails, yet these assets had little scrap value—what else could these assets be used for if not a railroad? . . . . Complicating the plight of insolvent railroads was an ineffective legal system; federal legislation was in a constant state of flux and limited state remedies proved inadequate because railroad lines, unlike state jurisdiction, generally extended across several states.
Id. at 585 (footnote omitted).
183. See id.
old management of the railroad, to take control of the corporate assets and run the business during the receivership.\textsuperscript{184} This brought the railroad's assets under the jurisdiction of the chancellor, thus insulating them from execution by creditors.\textsuperscript{185} Creditors' committees then developed a reorganization plan that specified what creditors would receive in exchange for relinquishing their claims to a court-appointed reorganization committee.\textsuperscript{186} The committee purchased the railroad's assets at a foreclosure sale and placed them in a newly formed corporation.\textsuperscript{187}

Interestingly, the Bankruptcy Act of 1898\textsuperscript{188} did not contain any provisions geared to corporate debtors, but when Congress amended the Bankruptcy Act by the Chandler Act\textsuperscript{189} in 1938, it added three separate chapters specifically designed for corporate reorganizations.\textsuperscript{190} Congress intended corporations to choose the chapter best suited to the size and complexity of the case. Chapter XI of the Act, however, eclipsed the other two chapters for several reasons: management remained in control of the corporation in chapter XI, thus insulating management from an independent trustee; management had the exclusive right to propose a plan of reorganization; the Securities Exchange Commission had less of a role in chapter XI cases; and chapter XI adjusted unsecured debts only, making it a simpler alternative to the more comprehensive adjustments available in other chapters.\textsuperscript{191}

In 1970, Congress created a Commission on the Bankruptcy Laws of the United States charged with reviewing the Bankruptcy Act.\textsuperscript{192} The Commission's review of the reorganization provisions of the Chandler Act led to the enactment of the present Code. Chapter 11 reflects both the fruits of the historical evolution of bankruptcy law and legislative compromise over perceived problems with previous law. I will now turn to the chapter 11 process as it exists today.

\begin{itemize}
  \item \textsuperscript{184} See id. at 586 (citing Investment Registry, Ltd v. Chicago & M. Elec. R.R., 212 F. 594, 609 (7th Cir. 1913); Duncan v. Mobile & O.R.R., 8 F. Cas. 25, 26 (C.C.S.D. Ala. 1879)).
  \item \textsuperscript{185} See id.
  \item \textsuperscript{186} See id.
  \item \textsuperscript{187} See id. at 586-87. The description of the equity receivership that follows is drawn from Professor Adams's excellent discussion. See id. at 585-87.
  \item \textsuperscript{188} Bankruptcy Act of 1898, ch. 541, 30 Stat. 544.
  \item \textsuperscript{189} Ch. 575, 52 Stat. 883 (1938).
  \item \textsuperscript{190} See Adams, supra note 160, at 587-90 (describing the Bankruptcy Act reorganization provisions).
  \item \textsuperscript{191} See id. at 589-90.
  \item \textsuperscript{192} See id. at 590-91.
\end{itemize}
B. The Chapter 11 Process

Upon the filing of a chapter 11 case, a "debtor-in-possession" ("DIP")\(^\text{193}\) of the bankruptcy "estate"\(^\text{194}\) takes control of "property of the estate."\(^\text{195}\) The DIP has the power to keep the debtor's business running during the chapter 11 process.\(^\text{196}\) The DIP is aided in running the bankruptcy estate by the "automatic stay," which arises by operation of law upon the filing of the bankruptcy petition. The stay enjoins any entity from taking any of the following actions: collecting on pre-bankruptcy debts; enforcing pre-petition judgments; obtaining property of the bankruptcy estate;\(^\text{197}\) creating or perfecting liens against estate property; and collecting any claim against the debtor that arose before the bankruptcy case.\(^\text{198}\) The stated purpose of the automatic stay is to give the debtor a "breathing spell" from creditor actions that would impede the DIP's efforts to reorganize the corporation.\(^\text{199}\) Bankruptcy courts also have the power to "issue any order,\(^\text{200}\)

\(^{193}.\) See 11 U.S.C. § 1101(1) (1994 & Supp. 1998) (defining a debtor-in-possession as "the debtor" except in a chapter 11 case where a trustee has been appointed); id. § 1107 (providing that a debtor-in-possession has most of the powers of a bankruptcy trustee). The Supreme Court has further stated that "it is sensible to view the debtor-in-possession as the same 'entity' which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have employed absent the bankruptcy filing." NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984).

\(^{194}.\) See 11 U.S.C. § 541(a) (1994) ("The commencement of a [bankruptcy] case... creates an estate.").

\(^{195}.\) See id. § 541(a)(1) (providing that the bankruptcy "estate" is comprised of "all legal and equitable interests of the debtor in property as of the commencement of the [bankruptcy] case").

\(^{196}.\) Indeed, the Code makes clear that the U.S. trustee has the power to run the debtor's business for the benefit of the bankruptcy estate. See id. § 1108.

\(^{197}.\) See supra note 195.

\(^{198}.\) 11 U.S.C. § 362(a) reads, in pertinent part:

Except as provided in subsection (b) of this section, ... [the filing of a bankruptcy petition] operates as a stay, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case . . . , or to recover a claim against the debtor that arose before the commencement of the case . . . ;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case . . . ;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.

Id. § 362(a).

\(^{199}.\) The House report explains the benefits of an automatic stay:

\(^{200}.\)
process, or judgment that is necessary or appropriate to carry out the provisions” of the Code, a power that courts have exercised to supplement the automatic stay, if necessary, to foster the reorganization effort.200

The DIP continues to operate the corporation through various powers granted to the DIP by the Code: to use, sell, or lease property of the estate;201 to obtain credit, in or outside the ordinary course of business;202 to assume or reject executory contracts or unexpired leases on behalf of the estate;203 to recover the debtor’s property in the possession of third parties;204 and to recover property for the bankruptcy estate through several avoiding powers.205 The debtor has the exclusive right to propose a plan of reorganization for the first 120 days of the case, and the exclusive right to have that plan accepted by creditors for the first 180 days.206 After this “exclusivity period,” any “party in interest” may file a plan.207

The DIP may be replaced with a trustee, but the presumption is that the DIP will run and reorganize the business in chapter 11.208 Before

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200. 11 U.S.C. § 105(a). Courts are prudent in invoking § 105, and generally only exercise their power in chapter 11 cases where pressure on key people related in some way to the debtor—such as guarantors or indemnitors of corporate obligations or other principals of the corporation—face creditor pressure which the court finds will interfere with the DIP’s ability to propose a plan of reorganization. See, e.g., A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1003-07 (4th Cir. 1986) (holding that a court must weigh competing interests when determining whether to grant relief); F.T.L., Inc. v. Crestar Bank, 152 B.R. 61, 63 (Bankr. E.D. Va. 1993) (utilizing a four-part test to determine whether to grant an injunction against creditors pursuing their debts).


202. See id. § 364.

203. See id. § 365.

204. See id. § 542.

205. See id. §§ 544-545, 547-550, 553.

206. See id. § 1121 (b), (c). These periods may be extended by a bankruptcy court “for cause” if the request is made during the original time period. Id. § 1121(d).

207. The phrase “party in interest” is not defined in the Code, but is interpreted quite broadly to include “anyone who has a legally protected interest that could be affected by a bankruptcy proceeding.” In re James Wilson Assocs., 965 F.2d 160, 169 (7th Cir. 1992). Two provisions of chapter 11 contain a list of parties who are included in the phrase “party in interest”, but neither list is exhaustive—“the debtor, the trustee, a creditors’ committee, an equity security holder’s committee, . . . or any indenture trustee.” 11 U.S.C. §§ 1109(b), 1121(c).

a bankruptcy court will displace the existing management of the debtor, the party seeking the appointment of a chapter 11 trustee must show, by clear and convincing evidence, something more than mere mismanagement of the sort likely to be present in every bankruptcy case. In an appropriate case, the court may appoint an examiner to investigate the debtor's affairs as necessary.

The Code contemplates other entities or parties taking an active role in the case. The United States trustee must appoint a creditors' committee, normally made up of the seven largest unsecured creditors. The primary purpose of the creditors' committee is to facilitate negotiations between the creditors and the debtor of a consensual plan of reorganization, though, as a practical matter, committees

"appointment of a trustee is the exception rather than the rule in chapter 11 cases"); see also Carlos J. Cuevas, The Myth of Fiduciary Duties In Corporate Reorganization Cases, 73 Notre Dame L. Rev. 385, 397-400 (1998) (discussing appointment of chapter 11 trustees and analyzing cases).

209. "The philosophy of chapter 11 is to give the debtor a 'second chance' and, consistent with such philosophy, current management should be permitted to identify and correct its past mistakes." Ionosphere, 113 B.R. at 168 (citations omitted); see also In re Colorado-Ute Elec. Ass'n, 120 B.R. 164, 174 (Bankr. D. Colo. 1990) (attempting to distinguish between mismanagement and the additional facts which militate toward the appointment of a trustee); Cuevas, supra note 208, at 397-98 (discussing mismanagement in chapter 11 cases).


211. The Code provides:

If the court does not order the appointment of a trustee under this section, then at any time before the confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including... any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management if the appointment is in the best interest of the creditors or automatically in certain large chapter 11 cases.


212. The United States trustee is an employee of the U.S. Treasury Department who has the general duty to monitor the administration of bankruptcy cases, particularly chapter 11 reorganizations, and investigate the operation of the debtor's business. See id. §§ 307, 321-322. The U.S. trustee may appear on any matter in the bankruptcy case itself. When the Bankruptcy Code was enacted in 1978, Congress sought to separate out the administrative duties from judicial decision-making, both of which previously resided in one person, the Bankruptcy Referee, under the Bankruptcy Act. See H.R. Rep. No. 95-595, at 89-91, 107 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6050-53, 6069.

213. Section 1102 of the Bankruptcy Code provides:

[A]s soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.


214. The Code provides that the creditors' committee may do the following:

(1) consult with the trustee or debtor in possession concerning the administration of the case;
are often not formed. Moreover, those committees that are appointed are hamstrung from having a large impact on the reorganization plan unless the DIP wishes to include the committee in shaping the plan.\textsuperscript{215} The Code’s only directive concerning the interaction of the creditors’ committee and the DIP is that they meet “[a]s soon as practicable” after the committee is formed to transact business.\textsuperscript{216} The congressional vision for a chapter 11 case is for the parties to negotiate a consensual, binding plan of reorganization that preserves the corporation’s “going concern” value, defined as the value of the corporation above its liquidation value.\textsuperscript{217}

\begin{enumerate}
\item investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
\item participate in the formulation of a plan, advise those represented by such committee of such committee’s determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
\item request the appointment of a trustee or examiner under section 1104 of this title; and
\item perform such other services as are in the interest of those represented.
\end{enumerate}

\begin{footnotes}
\footnotetext{215}{As Professor Cuevas has noted: [Chapter 11] fails to grant a creditors’ committee any authority concerning the day-to-day operations of the debtor, the development of a business plan, or the debtor’s restructuring. A creditors’ committee’s inability to have any input concerning the preceding matters not only places it in a powerless position, but also places the unsecured creditors in a similar position concerning the debtor’s daily operations and the debtor’s business plan. The estate might not have the funds necessary to compensate creditors’ committee counsel for litigation. . . . Consequently, debtor’s management is at liberty to proceed as it desires concerning the debtor’s day-to-day management, the debtor’s business plan, and the debtor’s restructuring . . . . Cuevas, supra note 208, at 396-97 (footnote omitted); see also Lynn M. LoPucki, The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?, 57 Am. Bankr. L.J. 247, 250 (1983) (noting that in a study in the Bankruptcy Court in the Western District of Missouri shortly after the enactment of the Code a creditors’ committee was appointed in only 40% of the chapter 11 cases studied, and that the trend appeared to be away from appointing committees in such cases).}
\footnotetext{216}{11 U.S.C. § 1103(d) (1994) (“As soon as practicable after the appointment of a committee under section 1102 of this title, the trustee shall meet with such committee to transact such business as may be necessary and proper.”).}
\footnotetext{217}{The legislative history states that the goal of chapter 11 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}
Theoretically, therefore, the parties capture the debtor's going concern value through the negotiation, confirmation, and implementation of a plan of reorganization.\textsuperscript{218} The Code does not dictate how the plan should be formulated, though it does spell out certain requirements that must be met before a court can confirm it. First, the plan must state how the DIP plans to structure and run the corporation's operations in the future.\textsuperscript{219} The bankruptcy court must determine independently that the DIP's plan for the corporation is feasible, in that it will not be followed inevitably by a liquidation of the company.\textsuperscript{220} The plan must divide creditors into "classes" holding "substantially similar" claims, and disclose how the members of each class will be treated.\textsuperscript{221} A threshold requirement is that each creditor in a class that is not being paid in full—that is, a member of an "impaired" class—can insist that they receive under the reorganization plan \textit{at least} as much as they would in a liquidation of the Debtor.\textsuperscript{222} Obvi-
ously, if the DIP cannot meet this "best interest of creditors" test, it makes no sense to attempt to formulate a plan of reorganization, as chapter 11 is an expensive alternative to a chapter 7 liquidation.\[224\] Furthermore, the plan must be proposed in good faith, and both the plan and its proponent must comply with all of the provisions of chapter 11.\[225\]

The pre-petition shareholders of the corporation normally receive nothing on account of their stock because impaired classes of creditors are entitled to insist on full payment before the equityholders receive anything.\[226\] Thus, "[c]reditors effectively own bankrupt firms."\[227\] In fact, their vote on the plan of reorganization determines the future of the corporation.

Creditors vote on the plan after the plan proponent has disclosed enough information so that a reasonable investor would be able to make an informed decision regarding the plan.\[228\] A plan is approved if half the creditors in number and creditors that hold at least two-thirds in amount vote to accept it.\[229\] If a class or classes of impaired claims reject the plan, the plan may be confirmed despite the vote of that class or classes if certain statutory conditions are met. One such condition is that at least one impaired class has accepted the plan.\[230\]

In sum, the chapter 11 process works by holding creditors at bay while the DIP works out a plan of reorganization. At that point, the creditors are divided into classes of similar claim holders, and then have their chance to vote. Once accepted by the creditors, the plan is judged through the Code's rules that preserve the creditors' non-bankruptcy rights, while at the same time forcing them to accede to the DIP's plan, sometimes against their will. I argue in the next part that this process (or one similar to it), which has evolved gradually

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226. This is the "absolute priority rule" which is codified at 11 U.S.C. § 1129(b)(2)(B)(ii). For a discussion of the process by which prior shareholders might receive an ownership interest in the reorganized debtor, see infra notes 302-05 and accompanying text.

227. Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1360 (7th Cir. 1990).

228. The plan proponent must file with, and have approved by, the court a "disclosure statement" that must contain information adequate to permit a "reasonable investor" to make an "informed judgment" concerning the plan. 11 U.S.C. § 1125(a), (b).

229. See id. § 1126(c).

230. See id. § 1129(a)(8), (b). This procedure is called "cramdown," which I discuss in more detail at infra notes 290-313 and accompanying text.
over time, is the only alternative to liquidating corporations if the goal is to successfully reorganize corporations.

III. AN "AUSTRIAN" THEORY OF CORPORATE REORGANIZATION LAW

Without an accurate understanding of markets and entrepreneurial action, there can be no free market model of the law of corporate reorganizations.\(^\text{231}\) If there is no principled economic justification for chapter 11, then its defenders are left only with appeals to tradition, and its critics understandably will insist that their notions of social justice ought to be engrafted onto the Code, or that chapter 11 be abolished altogether. Austrian economics is the key that unlocks the economic justification for chapter 11.

Simply put, chapter 11 is a market solution to the problem of corporate insolvency. It is just the type of process that Austrian economists identify as fundamental to human action in the marketplace, given the constraints of the real world. The ingenuity of chapter 11 is that it extends the market process for a limited period of time while simultaneously suspending and preserving the non-bankruptcy rights of creditors of the insolvent corporation. Not surprisingly, the historical development of bankruptcy law reveals an early and lasting commitment to such a dynamic, process solution to the problem of corporate financial distress. To date, however, the study of chapter 11 as a market process has not been influential in the search for an economic explanation for the chapter 11 process.\(^\text{232}\)

\(^{231}\) Professors O'Driscoll and Rizzo have observed:

Certainly, firm owners attempt to maximize their profits through the vehicle of their firms. The pattern of firm survival and the character of surviving firms is not simply the result, however, of conscious planning and rational profit maximization. The industrial landscape reflects both the results of conscious planning and the unintended consequences of entrepreneurial interaction in the marketplace. (Firms do not, for instance, normally plan their own demise.)

O'Driscoll & Rizzo, supra note 68, at 125.

\(^{232}\) One exception is Professor Donald Korobkin's model of bankruptcy law as a forum in which competing interests are transformed, over time, into a renewed vision of the corporation as a moral, political, social, and economic actor. Bankruptcy law creates conditions for a special kind of discourse, one that is fundamentally rehabilitative in character. No other legal system responds to the crisis of human values arising in financial distress, or provides for a discourse for rehabilitating these values into an informed and coherent vision of the corporation as personality.

Donald R. Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy, 91 Colum. L. Rev. 717, 766 (1991). In criticizing the creditors' bargain approach to chapter 11, Korobkin notes that, in contrast to the economic account, the corporate debtor in chapter 11 "should be seen not as merely a pool of assets; instead, the estate should be viewed as an evolving and dynamic enterprise, capable of having diverse aims." Id. at 721-22 (emphasis added). In the italicized phrase, Professor Korobkin has grasped the essential Austrian point—economic action takes place in the context of dynamic
A. Corporate Insolvency and Plan Coordination

The fundamental problem of chapter 11 law is not, as the creditors’ bargain theorists would have it, to “facilitate achieving the asset deployment of greatest benefit to the claimants [of the corporation] as a group.”233 If that is the proper question, it is indeed difficult to justify the time-consuming, cumbersome, and often expensive process of chapter 11. The effort to value a corporation’s assets so as to achieve an efficient bankruptcy result is a cousin of neoclassical economists’ struggle to justify why firms exist given their assumptions of perfect knowledge and equilibrium states.234 The traditional law and economics approach to chapter 11 falters because chapter 11 is indeed inexplicable if we assume that the going concern value can be accurately assessed and assigned by a court.

Rather, the fundamental riddle is: Why has the firm become insolvent? The Austrian theory of the firm explains corporations as an overlapping web of plans, guided in part by management who (presumably with the consent of the shareholders) set a path for the company through business strategy.235 The purpose of the firm is entrepreneurial action, which is facilitated through the coordination of the plans and knowledge of the firm’s members.236 Insolvency is a signal to all, inside and outside the firm, that the entrepreneurial plans which make up the firm have failed, or that the firm’s particular means of organizing and coordinating those plans and knowledge are flawed.

Some examples are in order. Perhaps management’s business strategy, which is executed by management at the behest of the shareholders, was mistaken from the start (e.g., concentrating on making buggy whips instead of automobile tires). In such a case, management must assess the previous plan, identify the error in their strategy, and determine how, if possible, to correct the problem given that the future course of events cannot be predicted objectively. In other words, management must act entrepreneurially.

234. Note Dean Jackson’s framing of the issue, and its neoclassical flavor: The critical question to be asked in examining the reorganization provisions, then, is whether there is a net gain to the common pool from proceeding with a reorganization instead of a liquidation. . . . Whether the process is a piecemeal liquidation, a going-concern liquidation, or a reorganization, nothing in the form of the process itself seems to call for a different standard of allocation among claims . . . in one type of proceeding than in another. Id. at 212 (footnote omitted). Dean Jackson is correct. Of course, if the only question is how to allocate a pool of resources, the exact nature of the process ought not make any difference.
235. See supra notes 141-56 and accompanying text.
236. See supra notes 141-56 and accompanying text.
Of course, insolvency might not be caused by a failure in business strategy. GM’s business strategy is to build automobiles that the public will buy. If GM cars do not sell, the problem might not be in management’s strategy or management’s plan for implementing it, but rather in the execution of the strategy by other members of the firm. For example, perhaps GM’s cars are not selling because they are ugly. This problem, once identified, might imply that the plans formulated by the design department have failed and need adjustment or reformulation.

A firm also might fail because of entirely exogenous circumstances that may or may not be temporary. For example, perhaps GM automobile sales plummet because the price of gasoline skyrockets due to temporary political problems in the Middle East. GM may or may not change its plans for how it produces its products (through producing automobiles with better gas mileage), but it likely would have to slow production and make other changes to its production plans. On the other hand, if an alternative mode of transportation is invented that the consumer chooses over automobiles in overwhelming numbers, GM might consider exiting the automobile business, or developing an entirely different plan for its corporate survival. Indeed, we need not assume such a stark change in technology to recognize that sometimes subtle changes in consumer tastes or technology might lead GM’s products to sit in their showrooms while competitors’ automobiles sell like hot cakes.

The reasons for insolvency may be more complicated than the preceding examples. There may be no single plan within the firm that has failed, but rather a concatenation of small failures or mis-coordination of plans might be to blame. A thorough review of the plans that make up the firm might be necessary in order to develop, test, and implement new plans and coordinate them with the plans of other firm members.

On the other hand, the problem might not reside in the plans of the firm’s actors or in their coordination, but rather in the very corporate routines or culture by which the firm fosters the localized discovery procedures of its members. Corporate routines are spontaneously generated over time and survive or are discarded as their efficacy is tested by the firm’s ability to meet the subjective desires of consumers. Though management can attempt to revise longstanding corporate routines or culture by command, institutional folkways often are resistant to uprooting.

Finally, the reason for the firm’s descent into insolvency might defy easy detection. In such case, corporate insolvency does provide information that is indispensable in the market process—a signal to those in charge of the corporation and to those to whom they are responsible that something is wrong. The entrepreneur need not be alert at all to receive this signal loud and clear, and thus notice the opportunity
for entrepreneurship. The problem in such case resides not in alertly noticing the opportunity for entrepreneurship, but, rather, in assessing how to correct the problem.

These admittedly simple examples are not meant to exhaust the list of possibilities. Rather, they demonstrate an important Austrian aspect of corporate insolvency. In a world of perfect knowledge of all relevant information, the firm’s actors would recognize the flaw in the firm’s plans, wherever it may be, and respond without any friction and without any time elapsing. In the real world of dynamic change in consumer tastes and desires, where time passes and the world in which we act is inherently uncertain, individuals’ plans and their coordination with others’ plans often fail. Once failure is apparent, in this case through insolvency, the trick is to discover the problem and correct it. Both steps require time, and neither step may be possible. Any legal framework whose goal is the reorganization of insolvent firms must provide, to the extent possible given the rights of creditors, a relatively free environment that replicates the market process. The entrepreneur must be given time, information, and some assurance that her efforts will be rewarded in the end. Thus, just as in the non-bankrupt corporation, the entrepreneur is the key to a successful reorganization.

B. Entrepreneurship and the Insolvent Corporation

As the entrepreneur of a solvent corporation is the driving force behind the firm’s success, the entrepreneur is also indispensable to the reorganizing corporation as well. The Austrian theory of the firm identifies several entrepreneurial actors within firms: (1) the shareholders and managers who set and implement the firm’s general business strategy; (2) “intrapreneurs” who act entrepreneurially within the firm to better integrate the plans of the firm’s actors or to improve the methods by which the firm coordinates local knowledge, either by command or spontaneously through routines; (3) the firm’s actors themselves (including, but emphatically not limited to management) who have joined their plans for market action with those of the other firm actors, and are engaged in the primary purpose of the firm—discovering knowledge which leads to the satisfaction of consumer desires in the marketplace.

Upon insolvency, one or more entrepreneurs from one or more of these categories must act to identify the reasons for the company’s financial distress. It is impossible to positively identify the entrepreneur at the moment the chapter 11 case is filed. Entrepreneurship within an insolvent firm requires time and freedom, just as time and freedom from interference is required outside the bankruptcy con-

237. See supra note 158 and accompanying text.
238. See supra Part I.E.
Moreover, the entrepreneur must be assured that her job is as stable as possible given the firm's insolvency. There is no guarantee that the entrepreneur's ideas will be heard and implemented. After all, in an uncertain world, it is impossible to predict perfectly today which ideas will succeed tomorrow. Thus, errors occur in assessing hypotheses, and sometimes the entrepreneur's ideas are ignored, even if they are the key to curing the firm's financial malaise. Finally, there is no guarantee that an entrepreneur of the sort described in this Article will emerge at all, no matter how favorable the environment.

Thus, the first opportunity for entrepreneurial action in an insolvent corporation is to identify the reasons why a firm is insolvent. It is reasonable to assume that the entrepreneur who successfully answers this question, if she is heard, will come from one of the categories of intra-firm actors mentioned above. This is not invariably so, however, and the reorganization process ought to take that fact into account. Even if this first question is answered by an entrepreneur, however, there is a second, equally important question to be considered: How should the error that caused the firm to become insolvent be corrected?

Answering this question presents a second, more challenging, entrepreneurial opportunity. Identifying the error with the firm's previous plan might be much easier than proposing a solution that will work. Even if a bright marketing executive at GM believes that the problem with GM automobile sales is that consumers find GM's car designs unappealing, and even if that marketing executive can convince the corporate decision-making team that she is correct, there is no guarantee that GM's design department can propose a solution to GM's design problems that consumers will find palatable.

Thus, the entrepreneur is confronted with the opportunity to discover a means to correct the firm's errant plans. Professor Harper's view of entrepreneurial action as a learning process founded upon the falsification of hypotheses is especially illuminating in this context. The entrepreneur must "learn" (in Professor Harper's sense of the term) what the flaw in the plan is. Once the entrepreneur has learned enough to identify the flaw, he must then suggest a new hypothesis and, if possible, test it in the market. This process requires time. Without time, the entrepreneur cannot act, and thus the firm stands no chance of being successfully reorganized.

Not surprisingly, given its roots, the chapter 11 process provides the entrepreneur with room and time to act. As described above, chapter 11 stops creditors from exercising their rights in order to give the debtor a breathing spell. The provisions of chapter 11 do not as-

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239. See supra notes 120-21 and accompanying text.
240. See Harper, supra note 7, at 165-205.
241. See supra note 199 and accompanying text.
sume how or by whom the kinds of entrepreneurial action described in this part will emerge, other than a general presumption that the entrepreneur will most likely rise from within the corporation itself. The automatic stay preserves the corporation’s assets and, perhaps, provides potential entrepreneurs within the corporation the assurance that their jobs are stable for the moment. The exclusivity period\textsuperscript{242} gives the \textit{intrapreneur} the first crack at proposing a plan, and thus further incentive to act. Leaving pre-petition management in place has a dual effect. First, the managers themselves might be the parties who will act entrepreneurially in locating and formulating a plan to cure the corporation’s ills. Second, even if the needed entrepreneur is not a member of management, it undoubtedly helps assuage potential intra-firm entrepreneurs to continue working with the same management that hired them in the first place. Thus, chapter 11 seeks to preserve the corporation, to the extent possible given its financial distress, as it was before bankruptcy to foster entrepreneurial solutions to the firm’s problems.

Viewed from a market process perspective, chapter 11 permits an internal process that mirrors how corporations act outside of bankruptcy. One crucial change in legal rights, however, results from corporate insolvency, even without a bankruptcy filing: The shareholders forfeit their ownership interests in the firm, and the creditors become in essence the firm’s “owners.”\textsuperscript{243} The filing of a bankruptcy case does not inevitably alter the ultimate rights of creditors in any major way, other than to prevent the creditors from fully exercising the remedies concomitant with their status.\textsuperscript{244} The endpoint of the intra-corporate entrepreneurial effort described in this part is the presentation to creditors of the DIP’s proposed plan of reorganization.\textsuperscript{245} At that point, the entrepreneurial focus shifts from the corporation to creditors.

C. Creditors as Venture Capitalists

The law traditionally holds that upon insolvency creditors become the residual owners of the firm.\textsuperscript{246} The automatic stay prevents the creditors from foreclosing on those rights or otherwise opting out of chapter 11’s collective proceeding.\textsuperscript{247} Creditors essentially become

\begin{enumerate}
\item \textsuperscript{242} See \textit{supra} note 206 and accompanying text.
\item \textsuperscript{243} See \textit{supra} notes 226-27 and accompanying text.
\item \textsuperscript{244} See \textit{supra} notes 198-99 and accompanying text.
\item \textsuperscript{245} See \textit{supra} notes 228-30 and accompanying text.
\item \textsuperscript{246} See Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1360 (7th Cir. 1990); Forum Group, Inc. v. Harrell, 181 B.R. 379, 383 (Bankr. S.D. Ind. 1995), aff’d, 82 F.3d 159 (7th Cir. 1996); Cristopher W. Frost, \textit{The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations}, 72 Am. Bankr. L.J. 103, 114 (1998).
\item \textsuperscript{247} See \textit{supra} notes 197-200 and accompanying text (discussing the automatic stay).
\end{enumerate}
in the firm to the extent of their pre-insolvency claims. The previous shareholders, having invested in a firm and directed the firm's plans in a way that led to insolvency, relinquish their investment. Thus, creditors, for better or worse, become the decision-makers when it comes to accepting or rejecting the firm's entrepreneurial plan. The creditors have no choice (other than ignoring the process entirely and receiving nothing) but to participate in chapter 11's collective process for making that assessment.

There is a problem, however, because creditors often are ill-equippeed, either by inclination or ability, to direct insolvent firms. Doing so requires too great an investment of time and resources in learning about the firm's plans and how they are coordinated. On the other hand, an insolvent firm "belongs" to the creditors. The rub is that chapter 11 forces creditors to do more than liquidate the firm, presumably because some firms ought to be restructured. The upshot of the chapter 11 process is that, at a minimum, the creditors have the right to screen the entrepreneurial plans that emerge from within the firm. Because a chapter 11 filing prevents the creditors from liquidating the corporation, at least for the moment, the creditors are forced by the chapter 11 process to act in a manner akin to a venture capitalist asked to invest in a start-up business. The creditors already have an "investment" in the firm up to the amount of their claims. In a chapter 11 case, the entrepreneurially-generated, internal plan for correcting the errors in the firm's previous plans is presented to the creditors, who have no choice but to evaluate those entrepreneurial ideas and interpret them in the face of uncertainty. The creditors as a body, however, do have one choice which flows from their right to evaluate corporate plans: whether to liquidate the firm or to invest in the new firm as reconstituted by the entrepreneur. Thus, the creditors must themselves act as entrepreneurs in deciding whether to accept the plan. Ultimately, the choice is theirs alone, a result that is consistent with their legal rights.

The view of creditors of an insolvent firm as analogous to venture capitalists is important because, as Professor Harper points out:

248. Professor Christopher Frost also distinguishes between "investors" in a chapter 11 debtor—those with a claim against the debtor as defined by the Code—and "non-investors"—defined as all other interested parties who do not hold such claims. See Frost, Redistributive Policies, supra note 11, at 79 n.16.

249. See supra notes 226, 246 and accompanying text.

250. See supra note 226 and accompanying text.

251. See supra note 226 and accompanying text (discussing voting on plans and cramdown).

252. "The [approach of Professor Harper] could be extended to the learning procedures of other transactors in the market process, such as venture capitalists, who evaluate entrepreneurial ideas and who face difficulties of interpretation." Harper, supra note 7, at 347.

253. See supra notes 228-30 and accompanying text (discussing voting on plans and cramdown).
The process of interpersonal criticism within the external venture capital market is especially pertinent as an object of study [for Austrian economics] because independent venture capitalists have been relatively successful in investing in innovative business startups. It has been suggested that the source of venture capitalists' success is the evaluation procedures and the rigorous selection criteria that they employ. Indeed, venture capitalists undertake intensive screening and analysis of the projects in which they invest. During the pre-investment phase, business proposals are subjected to successive stages of scrutiny: prescreening, screening, evaluation, and structuring and pricing the investment proposal. Thus, venture capitalist decision-making may be the paragon of critical rationalism in the context of the growth of market knowledge.  

In a chapter 11 case, the creditors do not have to screen investment proposals. They are presented with one proposal as a result of their legal rights in the debtor. They must evaluate the proposal, however, with reference to their subjective view of whether it will succeed in the marketplace.

Chapter 11 contemplates and, at least in part, facilitates this process. The creditors must receive all the information that a reasonable investor would require in making investment decisions before they are asked to vote on the DIP's plan of reorganization. If disclosure is insufficient, the creditors can object and will not be forced to vote on the plan. As described above, chapter 11 is intended to be a negotiation, not litigation. The creditors' contact with the DIP, through their committee, should lead to their involvement in the formulation of the plan.

I do not contend that the DIP must involve the creditors in the entrepreneurial action necessary to formulate a viable plan of reorganization. Rather, the largely unrealized emphasis on creditor involvement in the chapter 11 process is meant to educate the creditors early and completely regarding the venture in which they are being asked to invest. Without such information, the creditors naturally will be uncomfortable in accepting the DIP's plan, just as the venture capitalist will not invest in a poorly articulated speculative venture. Thus, chapter 11's stated aspirations to cooperation between the creditors and the DIP are in the best interest of both parties. The creditors' vote is the result of the disclosure of the DIP's plan and the creditors' evaluation of it. This vote is the creditors' chance to express their best, subjective evaluation of the DIP's entrepreneurship.

254. Harper, supra note 7, at 348 (citation omitted).
255. See supra note 228 and accompanying text.
256. See supra note 228 and accompanying text.
257. See supra Part II.B.
258. See supra notes 215-16 and accompanying text.
259. See supra note 246 and accompanying text.
D. Subjective Value

The last insight crucial to understanding chapter 11 is the concept of subjective value. Given the nature of the chapter 11 process, it makes little sense to speak of an objective “going concern" value that can be calculated with any reasonable certainty. The firm has a “going concern value" if the venture capitalist believes it does. In making the decision whether to invest, the venture capitalist is faced with uncertainty and imperfect information. After all, the previous owners of the firm invested in the firm's previous plan, which has now been proven erroneous. The venture capitalist cannot be certain that the plan now presented is correct in identifying the previous problems with the firm, or that the new plan is the solution to the problems identified.

Thus, the creditors must test the hypothesis presented (the plan) and vet it through a process of critical rationalism as described by Professor Harper. Because the creditors of a firm are often numerous and diffuse, with differing interests, difficult holdout problems arise in asking the creditors to speak in one voice. Depending upon the diversity and number of creditors, it should be no surprise that the creditors might institute their own procedures or structures to receive, process, and evaluate such information. Indeed, the Code provides an institution that creditors ought to employ in coordinating their collective decisions—the creditors' committee. If the creditors decide to invest—that is, if they accept the DIP's entrepreneurial plan—it is only because, in their subjective view, the proposed plan will work. There is no way for the creditors to objectively value the reorganized debtor. Rather, the creditors must rely upon their subjective knowledge of consumer tastes and desires, their best guess on a number of fronts regarding the future, and their subjective evaluation of the proposed plan given those assumptions. The creditors' evaluation of the plan is colored by two legal rights vis-à-vis the investment they have at stake in the debtor—their entitlement to insist that the plan provide them with what they would receive in a chapter 7 case (i.e., the liquidation value) and, that, if they ultimately are not convinced by the DIP's entrepreneurial efforts, a liquidation will be forced through conversion of the case to a chapter 7 proceeding.

In sum, the firm only has the value that someone is willing to pay for it. If the creditors evaluate the plan and accept it as a group, then, by definition, the reorganized corporation has a “going concern value." If the creditors reject the plan, then the firm does not. Such a

261. See supra notes 213-16 and accompanying text.
262. See supra note 223 and accompanying text.
corporation is by definition not worth more than the creditors' existing “investment,” and the firm ought to liquidate. Any other model of the process essentially substitutes the judgment of third parties for that of the creditors, and it is bound to fail.

E. Evidence from the History of Chapter 11

The historical antecedents of chapter 11 provide evidence of the central role of process in corporate reorganizations. Professor McCoid, in describing the history of early English bankruptcy laws, states that “[t]aken together, [early English statutes] reveal a natural progression from agreement to persuasion to coercion to statute, an evolution from bargain to rule that is familiar in other contexts as well as here.”264 Thus, English bankruptcy law evolved slowly, from early attempts at voluntary bargaining among creditors and debtors. As American bankruptcy law fitfully developed in response to nineteenth century economic disruptions, the law began to grapple with the problem of the inevitable insolvency of some number of corporations in the increasingly industrialized United States.

At the intersection of the Gilded Age and the Industrial Revolution in the late nineteenth century, the insolvency of railroads led creditors and equity courts to develop rules to govern what had been developed through voluntary bargaining among creditors.265 The court procedures and rules developed through trial and error in equity courts were eventually crystallized in the form of the Bankruptcy Act of 1898, later amended in 1938 by the Chandler Act.266 Not surprisingly, chapter XI of the Bankruptcy Act, which retained the essential features of the common law composition agreement—debtor flexibility, limited government control, debtor's management retaining the corporate reins—was the chapter used most frequently to reorganize corporations.267 Due to its relative popularity as a reorganization tool, much of the old chapter XI survived the enactment of the Code in 1978.268 Thus, the “institution” of chapter 11 indeed reflects the familiar process of rules developed by private parties over time, being formalized by courts in rules and procedures, and, eventually, codified as law.

The history of chapter 11 illustrates the gradual development of such a system as the nature and structure of corporations change over time. Indeed, chapter 11 is a hybrid of spontaneous development through necessity and legislative innovation begun in the distant past. The purely spontaneous growth of chapter 11 law was arrested by the

265. See supra notes 181-87 and accompanying text.
266. See supra notes 177-91 and accompanying text.
267. See supra notes 190-92 and accompanying text.
codification of equity court rules and procedures,\textsuperscript{269} combined with the statutory creditors' composition inherited by English law.\textsuperscript{270} One would expect that the codification process was imperfect, and that a few problems have arisen with the passage of time. Moreover, because most social institutions change over time, corporations and their structures also develop and change. Having proposed a theory of chapter 11 that seems consistent with its general structure and its history, it is fitting to examine the statute and nagging issues surrounding it with the Austrian model in mind.

IV. Applications of the Austrian Economic Approach to Chapter 11

Having outlined an approach to understanding chapter 11, the skeptic might ask: So what? What difference does this make for chapter 11? What does the Austrian approach explain, what does it fail to explain, what impact does it have on the ongoing efforts to reform chapter 11? This part surveys several issues that may have an impact by the Austrian explanation of chapter 11 outlined above.

A. The Debtor-In-Possession

The debtor-in-possession construct has received much attention, in both scholarly and professional circles. The discussion of the DIP centers around two perceived problems. First, because debtor's management remains in possession of the corporation in a chapter 11, running its day-to-day affairs and having the exclusive right to propose plans of reorganization for the first several months of a bankruptcy case, the incentive in many cases is for management to file for chapter 11 and string the case along when the debtor should not be seeking to reorganize at all. A second, and related, concern is that chapter 11 takes too much time and is too costly, and that this is due in part to the debtor's pre-petition management retaining control of the corporation. These criticisms must be understood in the context of the preference of bankruptcy judges, one which springs in part from the Code itself, for the debtor's management to remain in control of the debtor—except in the most extreme cases of corporate looting or gross corporate mismanagement.\textsuperscript{271}

From the Austrian perspective, the DIP construct makes sense if one accepts the idea that the entrepreneurial action that is necessary to formulate a reorganization plan will most likely come from within the corporation itself. It is a reasonable supposition, borne out by experience, that the parties that have the most at stake and that have the most knowledge regarding the firm, its plans, its store of knowledge,

\textsuperscript{269} See supra note 178 and accompanying text.
\textsuperscript{270} See supra note 180 and accompanying text.
\textsuperscript{271} See supra notes 209-12 and accompanying text.
and its corporate culture—that is, parties that already are part of the firm—constitute the pool from which the entrepreneur will emerge.\textsuperscript{272} The entrepreneur might be a member of management of the DIP, but this is not necessarily, or even often, the case. The purpose of the managers in a chapter 11 proceeding is to provide overall coordination necessary for the localized entrepreneurial process to occur. The potential entrepreneur will be more comfortable dealing with familiar faces, and this, in turn, will help encourage stability within the firm at a time when the firm’s plans are manifestly in disorder. Moreover, the managers themselves will be nodal points of local firm knowledge that would take time and expense for an outsider to acquire. From an Austrian perspective, the retention of pre-petition management helps foster the subjective milieu necessary for the entrepreneur to act and to coordinate that action with the plans of the firm’s ultimate decision-makers, the creditors.\textsuperscript{273}

One potential problem with this arrangement is that the plans of an insolvent debtor’s management might interfere with the necessary entrepreneurial action. Management is not likely to be the exclusive or even primary source of entrepreneurial action in an insolvent corporation. Though the plans and culture of senior management of a corporation may indeed be where the problem lies, it is certainly not usually the case that any one manager or group of managers has sufficient information to evaluate all possible avenues for entrepreneurial action that might possibly yield a plan that creditors will accept. Therefore, management is important and in some cases vital to the formulation of an entrepreneurial plan, but the retention of pre-petition management is by no means necessary in every case. Indeed, in some cases, pre-petition management might be a positive impediment to entrepreneurship.

\textsuperscript{272} Of course, a third party with no previous association with the firm might have the entrepreneurial idea upon which a plan could be formulated. Recognizing this, the Code puts a limit on the period of time during which the debtor has the exclusive right to propose a plan. Thus, the presumption that the entrepreneur will emerge within the firm is rebutted by the mere passage of time.

\textsuperscript{273} Ludwig von Mises forcefully makes this point about the relationship between entrepreneurs and managers in a general discussion of (solvent) corporations:

The entrepreneur determines alone, without any managerial interference, in what lines of business to employ capital and how much capital to employ. He determines the expansion and contraction of the size of the total business and its main sections. He determines the enterprise’s financial structure. These are the essential decisions which are instrumental in the conduct of business. They always fall upon the entrepreneur, in corporations as well as in other types of a firm’s legal structure. Any assistance given to the entrepreneur in this regard is of ancillary character only; he takes information about the past state of affairs from experts in the fields of law, statistics, and technology; but the final decision implying a judgment about the future state of the market rests with him alone. The execution of the details of his projects may then be entrusted to managers.

Mises, Human Action, \textit{supra} note 51, at 304.
A second potential problem is that exclusivity and the automatic stay combine to insulate the DIP almost completely from the very creditors who will be asked to invest in the plan the debtor will eventually propose. Despite the oft-repeated sentiment that chapter 11 is intended to be a process of bargaining between the DIP and the creditors, just as the composition agreement was at common law, there is little legally that creditors can do to force the DIP to negotiate and disclose information during the process. Creditors might quite reasonably deem such information important to evaluating the debtor's plan before it is presented publicly in anticipation of a vote to take place in short order. The creditors cannot force the debtor's management to come to the bargaining table, and thus are frozen out of the plan formulation process. Under chapter 11, the DIP does not have to include creditors or even the creditors' committee in the process of formulating a plan. Creditors' committees do not have much legal recourse in the face of a DIP that discloses enough information to meet its duty to speak to the committee, but does not negotiate with the committee in a meaningful manner regarding the plan. Creditors, understandably frustrated, may passively await the debtor's proposal with a suspicion that secrecy shrouds some intention to gain an unfair advantage over them.

Outside of the chapter 11 process, if a venture capitalist is not provided the information necessary to make what she considers an informed judgement regarding a possible investment, the investor simply walks away. Entrepreneurs act through rational criticism of plans. Without sufficient information regarding a plan that is presented to them, the entrepreneur cannot and will not act. Due to the collective nature of bankruptcy proceedings, creditor-investors cannot "walk away" except by voting down a plan, or litigating over the legal rules that govern plans in an attempt to convince the court not to confirm the plan. Both results are counterproductive if they are caused by dissatisfaction with the information provided to the creditors during the reorganization process.

As outlined above, there are two entrepreneurial steps necessary for a successful reorganization. Once a plan of reorganization has been proposed, the creditors must be convinced to invest in the plan. Previously, a third party referee was on the scene to supervise the reorganization effort. Presumably, this gave creditors some assurance that their interests were protected and, perhaps more importantly, that the referee was an information-coordinating "node" within the bankruptcy process. The referee was an neutral source for informa-

274. See supra notes 202-08 and accompanying text.
276. The author has frequently witnessed this himself.
277. See supra Part III.B.
tion regarding the DIP's progress in formulating a plan. When chapter 11 was first enacted, the referee position was split into two different offices, the Bankruptcy Judge and the U.S. trustee. Thus, there no longer is any neutral actor in the reorganization process who can act as a liaison between the DIP and the creditors. The result, from an Austrian perspective, is that Congress rightfully provided maximum scope for the DIP's entrepreneurial action, without concomitantly providing similar flexibility for creditors to act entrepreneurially.

The upshot is that the Code ought to foster a closer relationship between the DIP and the creditors during the plan formation process. Several possible solutions have been suggested. First, courts could take a more active role by devising mechanisms by which the debtor's management fulfills its obligation to negotiate and work with creditors through the plan negotiation process. Solutions of this sort, how-

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278. See supra notes 212 and accompanying text (discussing the U.S. trustee).
279. Professor Frost emphasizes the importance of leverage in the relationship between the debtor's management and creditors, and, suggesting that courts take a greater role in evaluating the behavior of the debtor's management using current chapter 11 provisions, concludes:

The Bankruptcy Reform Act of 1978 dramatically changed the governance of corporations reorganizing under its provisions by eliminating the requirement of a mandatory independent trustee. The chief purpose behind the presumption that the debtor's management would continue to run the business was to reduce the disruption of the general business operations throughout the reorganization process. The concept of a "debtor in possession" left management with far broader powers, however.

... .

If bankruptcy is believed to be simply a process for redeployment of assets and redistribution of claims against those assets on an economically efficient basis, management control and allegiances may introduce opportunities for strategic behavior that is inconsistent with the rationale of the process. Corporations that economically should be liquidated may be reorganized and vice versa. If, on the other hand, bankruptcy is viewed as a means through which losses can be distributed to pre-bankruptcy claimants while the corporation undergoing the process stays in business and continues to contribute to the community through providing employment, paying taxes, etc., the same strategic influences may infect the process.

The solution to these difficulties requires little structural reform. In many cases, courts may be able to approximate the non-bankruptcy governance system by including a determination of the corporation's asset value in the other factors they use to evaluate contested business decisions. By determining the asset value, courts may determine which group holds the residual claims on the corporation's assets. Like the non-bankruptcy system, the court could then give the views of that group on the business decision the most weight in the decision making process.

Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 Ariz. L. Rev. 89, 139-40 (1992). Naturally, an Austrian approach does not view chapter 11 strictly as an effort to redeploy corporate assets in an economically efficient manner or primarily as an opportunity to distribute losses to pre-petition claimants, but the essential insight regarding management incentives remains valid.
ever, risk the increased role of the bankruptcy judge in corporate entrepreneurial decision-making, a result that chapter 11 sought to avoid and that bankruptcy judges themselves are neither disposed nor equipped to undertake. Second, chapter 11 could be revised to re-adjust the incentives for the debtor's management to deal with the creditors during the formulation of the plan of reorganization. One possibility that has been proposed by scholars is to replace the debtor's management, either entirely or partially, with an independent third party who will make decisions in areas where the debtor's management would be most likely to elevate their own interests over that of the corporation. From an Austrian perspective, however, any such solution might undercut the advantage of having the debtor's management in place. Replacing the present system with a mandatory trustee in every case might simply solve a problem inherent in some cases at the expense of creating problems in others.

Recently, Professor Cuevas proposed a creditor "vote of no confidence" that would permit the creditors to vote collectively for the ouster of the debtor's management in favor of a party chosen by the creditors. From an Austrian perspective, the creditors, as investors in the insolvent corporation, ought to be able to replace management that is interfering with the creditors' ability to evaluate the very entrepreneurial plans whose formulation is crucial to the process. Such a no-confidence vote would be a last resort. Voting in a bankruptcy case is a cumbersome and expensive process that would eat up additional estate assets in the form of attorneys' and professional fees. Creditors ought to be willing to suffer small slights and minor friction with the DIP's management in order to save the expense of such a vote. If, however, in the subjective view of the creditors, the debtor's management must be displaced in order for the creditors to evaluate any entrepreneurial plan that emerges from the debtor, then, to use an old phrase, it's their nickel. The creditors, whose investment in the debtor is at stake in this process, are in the best position to gauge whether the efforts of the DIP will be successful.

Perhaps tension is inevitable between the DIP's role in formulating an entrepreneurial plan for the debtor's future, and the creditors who, themselves acting entrepreneurially, must evaluate it. Presently, chapter 11 fosters the former at the expense of the latter, and this imbalance ought to be redressed. Giving creditors the ability to hire new managers would provide an option for creditors that would not be

280. For example, Professor Frost suggests that judicial valuation of corporate assets ought to be employed to determine which group's voice should be weighted most in the reorganization process. See id.

281. See Adams, supra note 160, at 621-33 (proposing appointment of a trustee to make "fundamental bankruptcy decisions").

282. See Cuevas, supra note 208 (proposing a "vote of no confidence" for creditors).
exercised lightly. In the end, the creditors' subjective evaluation of the DIP's management and plans truly does matter. After all, the creditors' subjective view of the debtor's plan will determine the corporation's future. Some creditors inevitably will err in making this decision. Leaving this decision to them (instead of mandating it in every case or leaving it up to the bankruptcy court), however, is the best means by which the chapter 11 process can foster the necessary entrepreneurial action on the part of the creditors in evaluating the plan of reorganization.

B. The Role of the Bankruptcy Court

Much the same as law professors, bankruptcy judges and other bankruptcy professionals cannot agree on what constitutes "success" in a chapter 11 case. Some believe that a successful chapter 11 is one where a plan is confirmed. Others wish to account for the interests of the communities in which they live and work. Still others believe that chapter 11 ultimately is for returning as much money to the creditors as possible.

The Austrian model of chapter 11 makes it possible to better define the role that the bankruptcy court ought to play. First, the subjective nature of economic values such as a corporation's going concern value dictates that, to the extent possible, the bankruptcy court should not be in the business of making such calculations. Indeed, in railroad receiverships, the court's role was limited to setting a minimum bid, which the reorganization committee had to meet or exceed in order to purchase the debtor's assets. Similarly, the Code provides that creditors are entitled to insist that they receive on account of their claims at least what they would receive if the debtor were liquidated. In an ideal world of few creditors and no holdout problems, such a calculation would not be necessary. Instead, whatever the creditors negotiated by definition would reflect the proper subjective valuation of the corporation.

A core problem that bankruptcy seeks to cure, however, is how to formulate and effectuate a plan of reorganization in a world where there may be many, widely scattered creditors even in the most modest commercial enterprise. Moreover, though still fraught with the problems inherent in any hypothetical valuation of assets, it is generally the case that the liquidation value of hard assets can be measured

283. For an excellent general discussion of different perspectives on "successful" chapter 11 cases, despite one participant's gratuitous (though forgivable) pique at "misinformed professors" meddling with chapter 11, see Leif M. Clark et al., What Constitutes Success in Chapter 11? A Roundtable Discussion, 2 Am. Bankr. Inst. L. Rev. 229, 240-45 (1994).

284. See id. at 229.

285. See id. at 230.

286. See id.

287. See supra note 223 and accompanying text.
with greater accuracy than the "going concern value" of a corporation. The market for scrap presumably is larger, with many more participants, than the market for corporations as going concerns. The inability to calculate an objective "going concern value" means that market-based, chapter 11 reform proposals that hinge upon an auction or a reliance on a capital market evaluation of the corporation's "value" are doomed to failure in most corporate reorganization cases. Strangers to the corporation are at a great informational disadvantage when it comes to evaluating corporate financial information. The smaller the corporation, the greater the disadvantage, particularly in the face of a recalcitrant debtor. Moreover, unless the debtor is very large, the information necessary to construct or evaluate entrepreneurial plans of the debtor will not be publicly available. The only alternative is for entrepreneurs within the firm to formulate a plan for the creditors to critically evaluate.

Thus, the Austrian approach points to a very limited role for the bankruptcy court in assessing the "going concern value" of the corporation or the chances of success for the plan itself. It ought not to be the province of a government official—though that official is stipulated to be diligent, intelligent, and honest—to assess the economic value or viability of entrepreneurial plans. The bankruptcy judge is ill-equipped to process the information necessary to make decisions regarding the "feasibility" of a proposed plan, or to make any judgments about value beyond setting the liquidation price. Therefore, the Code should be amended to eliminate the "feasibility" requirement for confirmation of a chapter 11 plan. Such a determination ought to be made by the investors using their subjective assessment of the plan. It is the heart of the chapter 11 process. The corporation will survive if its owners accept the entrepreneur's designs for its future. If there is a legitimate problem with certain creditors' interests being protected through the plan confirmation process, the problem ought to be solved by revising chapter 11's voting procedures to ensure the appropriate voice for such creditors in the proceedings.

In a similar vein, all reform proposals that empower the court to evaluate a plan in light of other, societal considerations suffer from the same flaw. The court does not have the information necessary to evaluate a tradeoff between the interests of the creditors and other "stakeholders." Attempts to import redistributive ideals into the chapter 11 process doom reorganized corporations to failure, for the

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288. Professor Frost, has made this point eloquently, though from a slightly different point of view:
The bankruptcy process is institutionally incapable of resolving the loss distribution issues among all who are interested in the outcome of the case. Even assuming that the social costs accompanying business failure should be spread over a broad base, the judicial system is particularly ill-equipped to make the types of judgments required to distribute losses in a way that bears any resemblance to rational policy.
same reasons that government interference in corporate decision-making would doom corporations to failure outside of bankruptcy.\textsuperscript{289}

Having thus defined what the court should not do, it might fairly be asked: What should be the role of the court in a chapter 11 case? Simply put, the bankruptcy court should do what any court does best—settle the legal disputes brought before it. Chapter 11 should limit such disputes to the extent possible to those that safeguard (but do not meddle with) the process itself. Such litigation would, of course, include disputes over some of the core legal constructs necessary to the bankruptcy process—for example, the bankruptcy estate, order and priority of distribution and litigation over the viability and scope of claims. In sum, the court should recognize that a chapter 11 primarily is not a lawsuit, it is a forced workout of a troubled business. As such, chapter 11 ought to restrict the court's role as much as possible to questions of law, and permit the business people to take care of business.

C. Absolute Priority Rule and the New Value Exception

If a class of creditors does not vote for a plan of reorganization, the plan nonetheless may be (in the colorful language of the marketplace) "crammed down" their threats—that is, the plan may be confirmed over that class's dissent so long as certain requirements are met.\textsuperscript{290} One of those requirements is the absolute priority rule—no junior class of creditors or equity holders may receive or retain any property or value on account of that junior claim or interest unless senior classes of claims or interests consent or are paid in full.\textsuperscript{291}

The history of the absolute priority rule is rich and much debated, and I will not recite it at length here. Suffice it to say that the


\textsuperscript{290} Professor McCoid provides a brief summary of the history of the absolute priority rule in his article concerning the history of the bankruptcy discharge. See McCoid, Discharge, supra note 160, at 165-81; see also John D. Ayer, Rethinking Absolute Priority After Ahlers, 87 Mich. L. Rev. 963, 969-79 (1989) (arguing that the "statutory branch" of the absolute priority doctrine is not really statutory); Walter J. Blum, The Law and Language of Corporate Reorganization, 17 U. Chi. L. Rev. 565, 565-71 (1950) (discussing corporate reorganizations under the National Bankruptcy Act).
Supreme Court fashioned the absolute priority rule in the context of railroad equity receiverships. The Court later engrafted the requirement of absolute priority onto the Bankruptcy Act by deeming it a component of the Act’s requirement that a plan of reorganization be “fair and equitable.” The “fair and equitable” test, which silently subsumed the absolute priority rule, was codified in chapter X of the Bankruptcy Act with the passage of the Chandler Act. The effect of the rule was that a valuation of every debtor corporation had to be performed in every case. On the other hand, chapter XI of the Act only required that the plan meet the “best interests of creditors” test which entitled creditors to insist upon the liquidation value of their claims. As one commentator has noted, the “nightmare” of applying the absolute priority rule in practice led to debtors “vot[ing] with their feet” by overwhelmingly choosing chapter XI of the Act over chapter X.

The drafters of chapter 11 codified the absolute priority rule as a part of the test for whether a reorganization plan is “fair and equitable.” This decision was controversial due to the inherent tension...
between the "best interests of creditors" test and the absolute priority rule. Commenting on the drafters' concerns as they considered proposals for a middle ground between the two, Professor McCoid has stated:

[T]he role of . . . the owners of a corporate debtor required to effect a successful reorganization may range from a substantial, even indispensable, effort to virtually nothing at all. A fixed allocation between the extremes of absolute priority and best interests would fail to reflect important differences among the cases. And so, . . . Congress sought to provide incentives which would lead to debtor and majority creditor agreement on the subject. The debtor, who ordinarily formulates the plan, must make an offer attractive enough to avoid rejection by a creditor class which, if it occurred, would be followed either by the absolute priority required in a cramdown or by a liquidation. On the other side, the creditors risk liquidation and consequent loss of any share of a going concern surplus if they fail to come to terms. The theory is that the parties will bargain for a composition result which divides the going concern surplus to their mutual advantage.  

Thus, the absolute priority rule provides a legal constraint to protect creditors in addition to the best interests test (which I have characterized throughout this paper as protecting the creditors' "investment" in the debtor). The DIP (or any other plan proponent, for that matter) knows that if a class of creditors rejects the plan, then they are entitled to insist not just that their investment be protected, but that their non-bankruptcy rights to repayment of that investment before other, lower priority investors, will also be preserved. It is not surprising that in a scheme where bargaining within general procedural rules is the model, that any forced, group-imposed, solution to holdout classes of creditors will contain heightened substantive safeguards to protect the holdouts. After all, the holdouts might be right to hold out—there is always the possibility that the majority of creditors might vote to confirm a plan for reasons having nothing to do with the entrepreneurial merits of the plan. This problem is potentially heightened where one large creditor, often an under-secured creditor with a large deficiency claim, effectively controls the impaired class that votes in favor of the plan over the objection of other impaired classes. Though holdout classes in such a case may be overruled by a majority vote, their coerced investment is protected both in amount and in priority of payment due to the interplay of the best interests test and the absolute priority rule.  

300. McCoid, Discharge, supra note 160, at 190.
301. For general discussions of the absolute priority rule, see Ayer, supra note 292; Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. Rev. 738 (1988); Lynn M. LoPucki & William C. Whitford, Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. Rev. 125 (1990); Bruce A. Markell,
This naturally brings us to the uncodified "new value" exception to the absolute priority rule. The Supreme Court first explicitly formulated the new value exception in *Case v. Los Angeles Lumber Products Co.*, wherein the Court stated:

It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor.... Where [the necessity of funding a plan by old equityholders] exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.

The Court went on to define "new value" as a contribution "in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." The "new value" exception has never been codified, and does not appear in the Code. Thus, it is uncertain whether the Supreme Court's discussion of new value in *Los Angeles Lumber* survived the specific codification of the absolute priority rule in chapter 11. From a market-process perspective, however, the new value exception appears eminently sensible. It is true of many corporations, especially closely-held companies or those whose primary asset is one 

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303. *Id.* at 121.
304. *Id.* at 122.
305. Compare *In re Bonner Mall Partnership*, 2 F.3d 899, 907 (9th Cir. 1993) (holding that new value exception exists), with *Travelers Ins. Co. v. Bryson Properties XVIII*, 961 F.2d 496, 504-05 (4th Cir. 1992) (holding that plan which permitted limited partners to make new capital contributions was not "fair and equitable" to first mortgagee's unsecured claim). For a general discussion of the debate, see Tabb, *The Law of Bankruptcy*, supra note 170, at 874-80.

306. The Seventh Circuit agrees:

Creditors effectively own bankrupt firms. They may find it worthwhile, as owners, to sell equity claims to the managers; they may even find it worthwhile to give the equity away in order to induce managers to stay on and work hard. Because the Code allows creditors to consent to a plan that impairs their interests, voluntary transactions of this kind are possible. Only collective action problems could frustrate beneficial arrangements. If there are many creditors, one may hold out, seeking to engross a greater share of the gains. But the Code deals with holdups by allowing half of a class by number (two-thirds by value) to consent to a lower class's retention of an interest. Creditors not acting in good faith do not count toward the one-third required to block approval. When there is value to be gained by allowing a lower class to kick in new value and keep its interest, the creditors should be willing to go along.

Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1360 (7th Cir. 1990) (citations omitted).
piece of real property, that there is no entrepreneurial alternative to a capital infusion from existing shareholders. There simply might not be any other source of cash or expertise necessary for running the reorganized corporation. The existing shareholders, which often are also officers of the company, must make an additional investment, or the corporation will be liquidated. In such cases, an overly rigorous application of the absolute priority rule raises the specter of holdouts among the creditors. On the other hand, whenever shareholders of an insolvent corporation receive something under a plan, the creditors will be understandably suspicious of collusion between the shareholders and the DIP. Moreover, as Professor Tabb has pointed out, even if one accepts the notion that shareholders ought to be given the opportunity to fund a plan of reorganization, and that such a plan might be the only option in many cases, creditors are often upset because “they have no say in the matter, and no chance to offer a competing plan, or to make a contribution themselves.”

Thus, the practical interplay between the new value exception, where recognized, and the exclusivity period deprives creditors of the ability to negotiate effectively concerning the pre-petition equityholders’ position in the reorganized corporation where such shareholders present a “new-value plan.” The focus of the confirmation inquiry will be whether the shareholders’ new value is approximately equal to the interest in the reorganized company that those shareholders will receive under the plan. This, in turn, requires that the court discern the value of the shareholders contribution and their ultimate interest in the reorganized debtor. Though in any given case both valuations may be speculative, in almost every case the latter valuation will be a “guess compounded by an estimate.”

Scholars have suggested two ways to extricate creditors from the corner into which a DIP can paint them through a new-value plan. The first is to conduct an auction of the debtor’s proposed interests in the reorganized debtor. If a third party is willing to pay more for

308. See supra note 298.
the interest in the reorganized corporation than is granted to existing shareholders under a new-value plan, then presumably the court would "sell" that interest to the highest bidder. If there are no bidders, then the court may rely on the fact that a market-process valuation of the interest has revealed it to be at most equal to the amount of the new value injected by the old shareholders.

This ingenious solution is a step in the right direction, but I fear it suffers from the same problem as other market solutions in chapter 11 literature. It is difficult to believe, given present practical constraints on creditors' obtaining information from a DIP, that a third party often would have enough information on a timely basis to effectively gauge whether an effective plan could be formulated for the amount to be contributed to fund such a plan. Put in Austrian terms, there will be few instances where a third party could act entrepreneurially. A fortiori, one might doubt that there will often be third-party bids in such "new value auctions." The potential information advantages of the existing shareholders (who appointed the managers running the DIP) are too great to rely on this solution in all cases.

Professor Tabb mentions another possibility that holds greater promise: sever the link between exclusivity and new value. Under this proposal, once a new-value, cram-down plan is proposed, then the debtor's ability to keep dissenting creditors from formulating and submitting their own plans for creditor evaluation is ended. Some appropriate time period should be permitted for third parties to gather the information necessary to formulate plans on their own. The DIP should be required to disclose such information promptly. If alternate plans are filed, then the creditors would vote in order to determine which plan ought to be confirmed. If no alternate plans are filed, then the DIP may proceed with the confirmation of its plan without regard to the absolute priority rule, the investors having not proposed an alternative to participation by existing shareholders in the reorganized debtor.

This proposal has the enormous appeal of directing third parties to act within a dynamic context of plan evaluation and formulation, rather than engaging all parties in a complex dispute over valuations that are rightly described as mere conjecture. Moreover, if sufficient

311. See id. at 879. Indeed, as this Article went to press, the Supreme Court hinted very strongly that the link between exclusivity and new value plans be severed to avoid violations of the absolute priority rule. See Bank of Am. Nat'l Trust & Sav. Assoc. v. 203 N. Lasalle St. Partnership, No. 97-1418, 1999 WL 257031 (U.S. May 3, 1999).
312. See id.
313. See id.
opportunity for entrepreneurship is permitted, the process might yield plans that creditors as a body would consider preferable to that of the DIP. From an Austrian perspective, such a process is vital to successful entrepreneurship, and is the only effective antidote for the headache caused by the extant approach to evaluating and confirming new-value plans in those courts that permit them.

The foregoing are some of the bankruptcy issues that are illuminated by the insights of Austrian economics. I do not pretend that this discussion exhausts the possibilities. Indeed, I earnestly hope the opposite—that the Austrian economic approach outlined above will open additional avenues of scholarly inquiry.

D. Professors Frost and Korobkin, and the Purpose of the Chapter 11 Process

Finally, a word is in order about previous scholarly discussions of the importance of a process-oriented response to corporate financial distress. To a significant degree, Professors Christopher Frost and Donald Korobkin have grasped the importance of a process-oriented corporate reorganization statute, each from a different perspective.  

Professor Frost notes that a process is necessary in a world of uncertainty because "asset deployment decisions cannot be characterized as 'correct' or 'maximizing.' It makes sense to discuss asset deployment issues only in terms of the process through which such decisions are made."  

Frost states that "the process through which asset deployment decisions are made should locate decision-making power in the hands of those holding incentives to maximize economic value."  

Frost then goes on to emphasize the importance of bargaining leverage and economic self-interest in the corporate reorganization process in an effort (successful, in my opinion) to defend chapter 11 against reform proposals which give "non-investor" interests a role in the process through the agency of the bankruptcy judge.

I wholeheartedly endorse most of Professor Frost's conclusions, which flow from the Austrian premise that a process solution makes sense in an uncertain world.  

Frost does not, however, fully expli-
cate the implications of the chapter 11 process, nor does he provide a complete, subjectivist explanation for the inevitability of such a process and the centrality of entrepreneurship to it. As outlined above, Austrian economic theory opens the door to such an overarching justification for the chapter 11 process.\(^{319}\)

Professor Frost marshaled these conclusions largely in response to Professor Korobkin, who views bankruptcy as an attempt to grapple with “moral, political, personal, social, and economic” effects of corporate insolvency, including the effects on parties not directly involved in the bankruptcy case.\(^ {320}\) Korobkin calls his explanation of chapter 11 a “value-based” account that “[loosely speaking, . . . accomplishes a kind of ‘group therapy’: the values of the participants in financial distress are rehabilitated into a coherent and informed vision of what the [bankruptcy] estate as enterprise shall exist to do.”\(^ {321}\)

Thus, to Korobkin the corporation is like an individual in that it is a “moral, political, and social actor” with a personality that can change.\(^ {322}\) Chapter 11 recognizes a corporation’s “dynamic potential” and provides a means of “bringing the corporation’s dynamic personality into public view and regulating not merely its economic division, but the playing out of its moral, political, and social values.”\(^ {323}\) Chapter 11 is a “rehabilitative discourse”\(^ {324}\) that takes into account the interests of not only the parties to the bankruptcy process, but others affected by the prospects for the continued viability of the corporation as well.\(^ {325}\) Professor Korobkin obviously understands that process is the key to chapter 11. Rather than focus on the individuals who make up the firm as the locus of economic action, however, he anthropomorphizes the insolvent firm into a needy individual in need of rehabilitation through discourse. As the Austrian model outlined here

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\(^{319}\) See supra Part III.

\(^{320}\) Korobkin, *Rehabilitating Values*, supra note 11, at 721.

\(^{321}\) id. at 722.

\(^{322}\) See id. at 745.

\(^{323}\) Id.

\(^{324}\) This characterization of Professor Korobkin is attributable to Professor Frost. See Frost, supra note 11, at 87.

\(^{325}\) See Korobkin, *Rehabilitating Values*, supra note 11, at 762-63. These other groups include employees, the government, the community, shareholders, and potentially others. See id. at 763.
explains, though, Professor Korobkin’s approach misapprehends the reasons for the process.

First, chapter 11 has its roots in common law creditors’ compositions and in the railroad equity receiverships of the late nineteenth century. The evidence suggests that both historical antecedents of the chapter 11 process were devised solely for the benefit of creditors. Other parties affected by the success or failure of reorganization efforts were not given a seat at the table to air through group discourse their interests and views regarding the future “personality” of the debtor. On the contrary, creditors of railroads formulated reorganization plans that, in turn, were presented to a reorganization committee made up of creditors, who then effectively purchased the insolvent corporation through the plan for some value above the liquidation price. The equity court’s role seems to have been limited to sniffing out collusion in the form of too low a price paid for the debtor under the reorganization committee’s proposal.

Second, though Professor Korobkin’s “group therapy” might be viewed as a version of Professor Harper’s growth-of-knowledge model of entrepreneurship, it does not follow that interest groups other than the creditors are, or ought to be, included. Entrepreneurs tend to notice what is in their interest to notice. The Austrian entrepreneur applies her skills either to discover opportunities through alertness (Kirzner) or to hypothesize, falsify, and reformulate hypotheses in an effort to capitalize on perceived opportunities (Harper) all with the intent to remedy gaps in the market. Entrepreneurial action is essential to the process by which knowledge grows, innovation occurs, and consumer tastes and demands are satisfied.

The key, however, is ensuring that the entrepreneur’s attention is directed to noticing and capitalizing on such opportunities. When a corporation becomes insolvent, there are severe problems with coordinating intra-firm plans due to the disruption caused by a firm not paying its bills. Employees and other creditors may worry about getting paid. Key managers may wish to jump the sinking ship. Suppliers are wary of ongoing relationships with the insolvent corporation. In this atmosphere, only a continuation of the market process and pre-insolvency entrepreneurial action potentially will yield a plan that will result in a confirmed plan of reorganization. The introduction of other groups affected by the insolvency of the firm introduces the possibility of plans being introduced (and perhaps even gaining ascendancy) in the chapter 11 process that are not the result of a true

326. See supra notes 181-87 and accompanying text.
327. See supra notes 186-87 and accompanying text.
328. See supra notes 183-84 and accompanying text.
329. See supra notes 116-18 and accompanying text.
330. See supra notes 63-66 and accompanying text (discussing Kirzner).
331. See supra notes 116-18 and accompanying text (discussing Harper).
market process. Entrepreneurial action will not be directed at the ultimate goal of presenting a workable reorganization plan to the investors (the creditors). Thus, such plans will fail either because the investors will not accept them, or, being forced to accept the plan, it will ultimately not be successful in practice. Indeed, such proposals are, on a smaller scale and in a local context, no different than centralized economic planning on a market level, an experiment whose disastrous result Austrian economists such as Friedrich Hayek accurately predicted and explained long before it finally was rejected.

Conclusion

Austrian economics emphasizes methodological individualism, the subjectiveness of economic calculations, and human action in the face of uncertainty and the passage of real time. Traditional law and economics scholarship, which is derived from neoclassical economic models, largely has not explored these themes in examining the law. The result is that durable legal institutions are criticized as not having a rational, economic justification to support their expense. Into this vacuum rush those that wish to abolish such institutions entirely or reform them to fit their own notions of social justice.

This dynamic has played out in the context of corporate reorganization law through the debate between the “free marketers,” “traditionalists,” and others. Until now, however, there has been no attempt to view chapter 11 through the lens of Austrian economic theory. In doing exactly that in this Article, I conclude that the key to chapter 11 is that it provides a two-step process. Time and a relatively unfettered scope for entrepreneurial action are afforded in order to formulate a plan to reorganize the debtor corporation that the debtor’s creditors will screen, much as if they were venture capitalists.

This process, like the market process in general, will be imperfect. Creditors might be ill-equipped to act as venture capitalists. There may be perverse incentives on the part of the entrepreneur which leads to plans that are bound to fail. It is only by preserving the environment necessary for entrepreneurship, however, that the process can yield the innovation necessary to reconstitute the firm. Any theory of chapter 11 that ignores the central roles of time, uncertainty, and entrepreneurial action in reorganizing an insolvent corporation seeks theoretical precision at the expense of practical exposition.

Few legal scholars have embraced Austrian economics—I daresay very few have even heard of it. The Austrian economic approach, however, holds tremendous potential for the profitable study of legal

332. See Mises, Human Action, supra note 51, at 704 (“In labor disputes the parties are not management and labor, but entrepreneurship . . . and the salaried and wage-receiving employees.”).

333. See Hayek, Road to Serfdom, supra note 52.
institutions, particularly in fields such as antitrust, intellectual property, and corporate law. I believe this Article is an example of such work, and I hope that others will follow in the Austrian tradition.