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Ipso Facto Clauses

– Some Legal and Economic Aspects on Opting Out of Bankruptcy –

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Abstract

Contracting parties often make use of reciprocal so-called ipso facto clauses. Such a clause provides both parties with the right to terminate the agreement upon the other's involvement in bankruptcy proceedings, and thus makes costless exit possible (i.e. it excludes the solvent counterparty's liability for damages when terminating the contract). In modern insolvency laws ipso facto clauses are frequently outlawed.

In Sweden, the law concerning the reconstruction of businesses is the only one that contains such a ban. In liquidation bankruptcies, however, the situation is not as clear. Here and there, Swedish legislation states that the bankruptcy estate has a right to enter into the debtor's contractual relationships. Only some kinds of contract are affected, leaving e.g. licence agreements in a legal vacuum. Furthermore, none of the existing provisions are explicitly mandatory.

The rationale for nullifying ipso facto clauses is often argued to be the ultimate bankruptcy goal of estate maximisation. Because the debtor's assets are scarce and because creditors do not act in the interest of others, the creditors will tear the estate apart if they were given the opportunity. All to get paid ahead. That is, if bankruptcy laws do nothing about it. This standpoint is also the majority's view in Sweden. An ipso facto clause is argued to satisfy only one while being to the detriment of all. Thus ipso facto clauses should be nullified, notwithstanding the absence of explicit such rules. Or so the argument goes.

Contemporary bankruptcy debate can be – and ought to be – greatly improved. Instead of plunging head first into a narrow and defective perspective, the overall legal effects on behavioural patterns should be seriously contemplated. With the guidance of modern Law and Economics, and by bringing even corporate and security-related aspects to the forefront, such predictions can be made.

Among other things, this thesis will show that the goal of collectivisation (i.e. maximising the value of the estate) must not be taken as a pretext for holding that all bankruptcy-related matters are subject to mandatory rules. By closely examining the very foundations of contemporary Swedish scholarship, it will further prove the majority's attitude towards ipso facto clauses to be wrong.

Instead of being to the detriment of the creditors as a group (i.e. the estate), ipso facto clauses are shown to improve overall welfare. By providing the debtor (when solvent) with greater access to business funding, as well as with better incentives to invest, the *ex post* value of the estate will actually increase. Thus, the ultimate bankruptcy goal of estate maximisation will in fact require that ipso facto clauses be sustained, not the other way around.

Contents

Abstract	1
Contents	2
Abbreviations	4
1. Introduction.....	5
1.1 Thesis Subject Matter	5
1.1.1 <i>Insolvency Calls For a Wider Perspective</i>	5
1.1.2 <i>License Agreements and Ipso Facto Clauses</i>	5
1.2 Methodological Issues and Thesis Demarcation	6
1.2.1 <i>Law and Economics – Method and Means</i>	6
1.2.2 <i>General Demarcations and Thesis Outline</i>	7
1.2.3 <i>Remarks on Terminology</i>	8
PART I: HISTORICAL AND CONCEPTUAL FRAMEWORK.....	9
2. The History and Concepts of Modern Insolvency Law	10
2.1 Evolution of Modern Insolvency Law – A Narrative Outline	10
2.1.1 <i>The Modern Insolvency Procedure: A History of Debt Collection</i>	10
2.1.2 <i>The Rise of a “Rescue Culture”</i>	12
2.2 Ipso Facto Clauses Frequently Outlawed.....	15
2.2.1 <i>The American Bankruptcy Code</i>	15
2.2.2 <i>The French Insolvency Act</i>	16
2.2.3 <i>The German Insolvency Act</i>	16
2.2.4 <i>The English – Divergent – Position</i>	16
2.2.5 <i>The Swedish Reconstruction Act</i>	17
2.3 Contemporary Law: Alternative Means of Categorisation.....	17
2.3.1 <i>On What We All Agree: The Common Ground of Insolvency Law</i>	18
2.3.2 <i>Insolvency Law From a Debtor-Creditor Perspective</i>	18
2.3.3 <i>Insolvency Law as a Reflector of Public Policy</i>	19
2.3.4 <i>The Economics of Insolvency Law</i>	20
3. American and Swedish Insolvency Law: A Brief Comparison	21
3.1 The United States: One Federal Code	21
3.1.1 <i>A Unified Procedure: Debtors and Creditors Can File for Bankruptcy</i>	21
3.1.2 <i>Property of the Estate. Avoidance and Abandonment Powers</i>	22
3.1.3 <i>The Automatic Stay</i>	23
3.1.4 <i>The Distribution Scheme</i>	23
3.1.5 <i>Executory Contracts Revisited</i>	24
3.2 The Swedish Position: Two Separate Laws.....	25
3.2.1 <i>Two Regimes: Different Prerequisites and Different Prerogatives</i>	25
3.2.2 <i>Property of the Estate. Avoidance and Abandonment Powers</i>	26
3.2.3 <i>Stay on Private Enforcement</i>	27
3.2.4 <i>The Distribution Scheme</i>	28
3.2.5 <i>The Debtors’ Contracts: An Area of Some Confusion</i>	29
3.3 Synthesis of Comparison.....	31

PART II: ECONOMIC ANALYSIS OF BANKRUPTCY LAW	33
4. The Economics of Orderly Liquidation.....	34
4.1 “Grab” Law and the Common Pool Problem.....	34
4.2 The Creditors’ Bargain: A Compulsory Liquidation Regime.....	35
4.2.1 <i>The Advantages of a Collective Regime</i>	36
4.2.2 <i>The Inclusion of Secured Creditors</i>	37
4.3 Creditor Entitlements and Forum Shopping	37
4.3.1 <i>Bankruptcy as a “Nexus of Interests”</i>	37
4.3.2 <i>Strategic Gamesmanship and the Troubles of Transition</i>	38
4.3.3 <i>Bankruptcy Law Should Curtail – Not Create – Perverse Incentives</i>	39
4.4 Some Features Peculiar to Bankruptcy	40
4.4.1 <i>The Concept of Relative Values</i>	40
4.4.2 <i>Nullification of Certain Pre-Bankruptcy Activity</i>	41
4.4.3 <i>Individual Actions Barred During the Procedure</i>	42
4.5 Property of the Estate – Assets and Liabilities	43
5. The “Magic” of Mutually Unperformed Contracts in Bankruptcy	45
5.1 Bankruptcy Treatment of Mutually Unperformed Contracts.....	45
5.1.1 <i>A Bundle of Rights (Assets) and Obligations (Liabilities)</i>	45
5.1.2 <i>Expectation Damages and Efficient Breach</i>	47
5.1.3 <i>The “Ratable” Damages Rule and Creditor Equality</i>	47
5.1.4 <i>Welfare Implications and the Problem of Excessive Rejection</i>	49
5.1.5 <i>The Impact of Property Rights and Avoidance Powers</i>	50
5.1.6 <i>The Evaluation of Mutually Unperformed Contracts in a Nutshell</i>	52
5.2 The Economics of Ipsa Facto Clauses	52
5.2.1 <i>Ipsa Facto Clauses and Estate Maximisation</i>	53
5.2.2 <i>The Coase Theorem and Bargaining Ex Post</i>	54
5.2.3 <i>Income Distribution and Voluntary Creditors</i>	55
5.2.4 <i>Ipsa Facto Clauses and Efficient Incentives to Invest</i>	56
5.2.5 <i>The Problem of Excessive Rejection Revisited</i>	57
6. Summary and Conclusive Remarks.....	59
6.1 Ipsa Facto Clauses Should Prevail.....	59
6.1.1 <i>The Limits of Orderly Debt Collection</i>	59
6.1.2 <i>A Functional Approach to Property and Contracts</i>	60
6.1.3 <i>Ipsa Facto Clauses Improve Social Welfare</i>	60
6.2 Final Comments on the Swedish Position.....	61
6.3 A Modest Proposal for Legal Reform.....	61
Sources and Literature.....	63

Abbreviations

DIP	Debtor in possession
ED	Expectation damages
FrekL	Lag (1996:764) om företagsrekonstruktion (Swedish Reconstruction Act)
FRL	Förmånsrättslag (1979:979) (Swedish Priority Act)
KL	Konkurslag (1987:672) (Swedish Bankruptcy Act)
LGL	Lönegarantilag (1992:497) (Swedish Wage Guarantee Act)
PatL	Patentlag (1967:837) (Swedish Patent Act)
R&D	Research and Development
RD	Ratable damages
UB	Utsökningsbalk (1981:774) (Swedish Seizure Act)
U.C.C.	Uniform Commercial Code
U.S.C.	United States Code
VML	Varumärkeslag (1960:644) (Swedish Trademark Act)

1. Introduction

I think all students of bankruptcy law are left with one first, and main, impression. The estate as such must be protected, for the creditors not to tear it apart. Because creditors are not of an altruistic turn of mind, they will seize every opportunity to get paid in the face of others. That is why bankruptcy laws came about. And what the law does not permit, the creditors may not do.

1.1 Thesis Subject Matter

Based on the aforesaid notion, my interest for creditor “opt-out” activity awoke. I thought that because insolvency is destructive to the creditors’ expectations, they ought to have an interest in opting out, e.g. through the use of ipso facto clauses (clauses permitting a party to costlessly exit from the agreement upon the other’s involvement in insolvency proceedings). The frequent use of such clauses in e.g. patent license agreements seems to be strong evidence for the latter standpoint. And so do the legislative tendencies to nullify them.

In Sweden the position regarding bankruptcy treatment of ipso facto clauses is theoretically obscure, or undetermined at least. Rest assured that the dominating view is based on the assumption of a creditor-estate conflict, a view that has however been subject to some criticism. To my view, the opponents should not stand unanswered. Rather, any bankruptcy policy that allegedly contradicts such a standpoint should be theoretically vindicated. But in Sweden, contemporary bankruptcy theory does not possess the tools by which its critics can be refuted. It is not enough to say that the estate needs preserving, when the question asked is why it should be preserved in the first place. Indeed, this thesis will suggest that the opposing scholars are right, and that the notion of a creditor-estate conflict is farfetched, to say the least.

1.1.1 Insolvency Calls For a Wider Perspective

The impact of bankruptcy is sometimes circumscribed. For example – quite contrary to the estate’s interests – all developed jurisdictions allow creditors to secure their debts in one way or another. And although securities are clearly of an opt-out character, they are apparently legitimate. At the same time it has been held that ipso facto clauses are not. To fully understand bankruptcy theory, one apparently has to understand more. Furthermore, the incentive to opt out of insolvency ought to increase alongside the amount at stake as well as the risk involved. Given my wishes to deal with insolvency from an opt-out perspective, a corporate context of some magnitude thus seems to be the ideal working place.

1.1.2 License Agreements and Ipso Facto Clauses

An appropriate corporate context can be found inter alia in the Research and Development (R&D) sector. Acting on global markets, mainly with intangible assets and with a substantial financial need during long periods of development, these compa-

nies are extremely volatile. And with increased risks, opt-out activity ought to increase as well.

Not unlike other corporations, R&D companies will enter into various contractual relationships. To finance projects debt must be incurred, and thus credit arrangements must be made. To pursue these business projects, other contracts must be entered into as well. Being so wonderfully complex, the typical licence agreement (if there is one) seems to be the appropriate working ground for this thesis. This is especially so, because parties to such contracts obviously and frequently make use of reciprocal ipso facto clauses.

1.2 Methodological Issues and Thesis Demarcation

It is customary to provide the readers of academic products with a theoretical starting-point. This thesis will prove no exception. To my mind, such a point of departure should come with some desirable features. First of all, the theoretical underpinnings should be clearly accounted for. Only by providing an entirely transparent product, can it be of constructive use to others. Furthermore, all scholarship must be kept within certain boundaries. One can not set out to answer all, when there are limits to time as well as to intellect.

1.2.1 *Law and Economics – Method and Means*

Even though the question regarding the legitimacy of ipso facto clauses has been on the Swedish agenda for a couple of decades, legal scholars have not been able to provide but a map of various and mutually incompatible arguments. Obviously the diverse standpoints need to be brought together and dealt with in a comprehensive manner.

Law aims at influencing behaviour. Yet, legal scholarship does not possess the tools for analysing such behaviour, nor does it show much interest in doing so. By relying entirely on “legitimate” sources of law, legal scholars guess – rather than predict – what effects a chosen solution may have. To escape this theoretical limbo, I have chosen to seek guidance in modern Law and Economics. To my mind, economic insights provide excellent aid – and do not run contrary – to contemporary jurisprudence.

The reader is presupposed to possess some previous knowledge of Law and Economics, primarily of the “Chicago-approach” that will be applied in the following.¹ From a price theory perspective, humans as well as corporations are to be regarded as rational economic agents, reacting to price adjustments in their pursuit of profit maximisation. In a perfect world their endeavours would inevitably lead to an optimal outcome (market equilibrium). In the presence of market imperfections, legal solutions should also promote social welfare (or maximise wealth). The goal of wealth maximisation ultimately rests upon a notion of *ex ante* compensation, meaning

¹ For a general update, see Mercurio et. al., *Economics and the Law. From Posner to Post-Modernism*, especially pp. 13 et. seq. and 57 et. seq. and Polinsky, *An Introduction to Law and Economics*.

that economic agents that could potentially be compensated have in fact reaped the benefits from efficiency on an earlier stage.

The economic implications of insolvency law have mainly been explored in the United States, while in Sweden no comprehensive such literature exists. Before applying any foreign theory in a domestic context – or for that matter being able at all to comprehend a foreign scholarly discussion – it is necessary to understand at least roughly how the foreign system works. Thus, this thesis will provide a brief comparison between the American and Swedish insolvency regimes. To further enhance the readers' general conceptual understanding of insolvency law, the comparison will be made against the backdrop of a historical exposé comprising a limited number of important jurisdictions. What is striking is that – from a procedural perspective – the concepts of insolvency law are roughly the same throughout the world. The only discernible differences seem to have arisen in the last century, as a political reaction to industrial expansion. But apart from recent trends in favour of debtor rehabilitation, insolvency legal concepts remain intact.

1.2.2 General Demarcations and Thesis Outline

The initial historical and conceptual survey (Part I) will comprise only a total of five jurisdictions, of which two will be subject to more extensive treatment. These countries are consciously chosen because they generally represent – through their legal influence on others – a significant part of the international community. Naturally, ipso facto clauses will stand in the centre of comparative attention, but even scholarly approaches of a more general character will be briefly presented here.

When narrowing the thesis to a closer scrutiny of Swedish insolvency law (Part II), it will also be further demarcated to comprising liquidation bankruptcy only. This is done for a number of reasons. First, the rationale for debtor rehabilitation seems to be different in different jurisdictions, while liquidation concepts are quite similar. Secondly, and more important, the Swedish attitude towards ipso facto clauses is quite clear in a reconstruction context: They are subject to an explicit statutory ban.

To further refine the analysis, I have chosen to deal with corporations only. Both the debtor and her solvent counterparty are thus presumed to be legal entities. Because the primary interests of a corporation are of a strictly monetary nature, this way the discussion will not be obscured by empathy for individuals or other ethical concerns. A consequence from dealing with firms in the R&D sector is that significant values often are intangible ones. When a corporation's assets do not suffice in satisfying all of her creditors, we must thus concentrate on isolating the dynamic features of ownership interests instead of building on the theoretical framework created in a traditional industrial context.

Bankruptcy involves procedural as well as substantive matters. The economic analysis (Part II) will embrace both, however on different levels. The procedural aspects are of general importance to bankruptcy theory, and thus will be treated alongside the bankruptcy institute itself. Ipso facto clauses, arguably being a matter of non-bankruptcy character, will be the only substantive interest dealt with in some detail. Hopefully this analysis will provide some insights of a general character as well, thus being of some aid when assessing different “opt-out” rights, such as securities.

The different arguments of bankruptcy scholars relating to ipso facto clauses will not be dealt with extensively. Instead I will take up a broad-brush focus on the theoretical bedrock on which they rest. If I were to set out to invalidate years of Swedish scholarly debate after a couple of months of research, it would be clearly presumptuous. Thus any proposals I might make should be regarded as being of a merely persuasive character. Yet it seems to me that, once their erroneous foundations have been revealed, many arguments can be effectively refuted even on a level of some detail.

1.2.3 Remarks on Terminology

Modern “insolvency” laws usually comprise both a liquidation procedure and a procedure for debtor rehabilitation. The Swedish system, however, is divided in two separate legal regimes, and for that reason it would be misleading to refer to Swedish insolvency law, unless when doing so on a general level. Thus, reference to “insolvency” will be made when relating to a debtor’s financial predicament or when relating to laws that generally cover debtor default. “Rehabilitation” (or “reorganisation” or “reconstruction”) regimes will not be labelled in a uniform manner, since correct reference will usually not cause any confusion.

The term “bankruptcy” (used in the United States) emanates from a medieval custom in the merchant cities of northern Italy, called *banca rupta*. When a banker or a tradesman made off with property belonging to his creditors, his bench was broken and his deceit thus made public. Being at least implicitly retributive, “bankruptcy” can thus be argued as being an inadequate choice of words in modern times. From an economic perspective the Swedish terminology regarding liquidation seems to be rather appropriate. When a debtor is liquidated, it is referred to as “konkurs”, emanating from Latin terminology (*concursum*) and implicitly referring to the race between creditors that will occur when the debtor’s assets are on the decrease. However, since the discussion will be closely linked to economic scholarship in the United States, I have found it impractical to deviate from American legal parlance. Thus, I will usually refer to “bankruptcy” when in fact dealing with what should properly be called “liquidation” (or “konkurs”). The latter term will be used only when dealing with issues unique to liquidation.

In Part II, abstract reason will be supported by frequent (and fictitious) exemplification. To avoid confusion, in such examples the trustee and other individuals will be assumed to be masculine (“he”), whereas a corporation will be thought of as feminine (“she”). The bankruptcy estate will be regarded as gender-neutral (“it”). Again, for practical reasons, I have consciously refrained to deviate from American ways of putting things. For example, monetary units are referred to as \$. To my mind, this does not necessarily cause pedagogical drawbacks.

I have tried to refrain from creating new standards, such as abbreviations. Instead I have maintained the conventional Swedish ones.

PART I: HISTORICAL AND CONCEPTUAL FRAMEWORK

2. The History and Concepts of Modern Insolvency Law

This chapter will take a start in ancient Rome and, after covering a period of some 1500 years, will end up in modern times. Gradually the survey will narrow into comprising only five important jurisdictions. England, France, Germany, Sweden and the United States of America will be subject to closer scrutiny, with a special focus on their treatment of so-called ipso facto clauses. After finally briefing through some scholarly discourses of today, we will see that the historical function of bankruptcy law is one of orderly debt-collection only. We will also see that some of the present-day scholars (and occasionally lawmakers as well) are very much concerned with protecting societal interests from the evils peculiar to corporate insolvency. The latter view is however not uncontested.

2.1 Evolution of Modern Insolvency Law – A Narrative Outline

With the rise of civilisation came the emergence of credit and, as an inevitable consequence, came debtor default. In this part the historical concepts of insolvency law will be explored. The survey's primary purpose is to provide an appropriate background for modern bankruptcy analysis. As we shall soon become aware, it will not only be of general interest, but will also provide excellent guidelines for positive as well as normative insolvency analysis of today.

2.1.1 *The Modern Insolvency Procedure: A History of Debt Collection*

In ancient communities of tribal character debt was not usually incurred, however on rare occasions it was necessary. History implies that, according to prevailing customs, debtor performance was frequently secured through the taking of hostages. The creditor was offered e.g. a friend or a kin of the debtor, who was to become the former's property if the latter could not pay as due. The debtor could also physically surrender himself. In ancient Rome these customs were gradually institutionalised, the former into a kind of surety contract, called *sponsio*, and the latter as a more straightforward system for human "collateral", called *nexum*.² Regardless of institution, the debtor thus faced the risk of being killed, enslaved, imprisoned or sold upon default. A remarkable feature of early Roman law is that it gave a plurality of creditors the right to physically divide the debtor among themselves by cutting him in pieces.³

Alongside an increase in commercial activity, as well as the development of contract law, the retributive character of debt enforcement was successively reduced and state supervision introduced. Following from the first embryo of modern bankruptcy procedure – the *venditio bonorum*, in force at least by 188 BC – a trustee was given the powers to audit and collect all of the debtor's assets (fraudulent pre-petition transfers could be legally reversed as well). Then the debtor's assets *and* liabilities were "sold" – or rather proportionally transferred according to the highest offer – to a legal suc-

² Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-4 et. seq.

³ Kilpi, *The Ethics of Bankruptcy*, p. 9; Olivecrona, *Konkursrätt*, p. 4.

cessor, thus spreading total loss among diverse creditors.⁴ The debtor, however, was still outlawed as well as humiliated.

In the centuries to follow, the *venditio bonorum* was on the decrease, partly due to public empathy towards bona fide debtors.⁵ And by the beginning of our era, it was formally recognised that a debtor could be in default due to circumstances beyond his control. If he could prove force majeure, the debtor could seek relief under an alternative procedure, called the *cessio bonorum*, by voluntarily surrendering his entire estate to the creditors. An assignment was made for the benefit of the creditors, and private executions were stayed.⁶ And the debtor escaped imprisonment.

During the 2nd century AD new procedures for coerced debt collection saw the light of day. Single creditors were able to satisfy their claims against a solvent but unwilling debtor through a remedy called *pignus in causa iudicati captum*, according to which their claims were satisfied through a forced sale of certain assets. Probably the first creditor to file was given priority and the surplus if any was returned to the debtor. If there were more than one creditor, however, they would resort to the so-called *distractio bonorum* procedure. In this case the debtor – besides being slandered – was deprived of all his assets (pre-petition transactions could be restored as well), and after a piecemeal sale on auction the proceeds were distributed among the creditors, presumably on a *pro rata* basis. Unlike the previously described *venditio bonorum*, the primary focus of this procedure was the debtor's assets, not the debtor himself.⁷

During the same period a kind of composition proceeding, named *remissio*, was established. And some centuries later another legal innovation, the *dilatatio*, provided for a so-called “moratorium”, during which certain pitiful debtors were granted a breathing spell to sort their business out.⁸

After the fall of the Roman Empire, civilisation as well as commerce declined for a number of centuries or at least sunk to a lesser degree of sophistication. Through the work of the Glossators in Bologna and their successors, from the 11th century onwards, classic insolvency laws were however revived (and refined), complementing the creditor remedies already in place. Seemingly a collective procedure was necessary, owing the fact that creditors tried to shut each other out by obtaining priority through private executions. Thus, the *distractio bonorum* reincarnated in Italy and was widely practised in its northern merchant cities during the 13th-14th centuries.⁹

In France, instead the *cessio bonorum* was initially embraced, and it was not until the 15th century that the French adopted – under the Italian influence – proper bankruptcy proceedings for use at their annual fairs.¹⁰ A similar progress can be seen throughout Europe. In Germany as well as in England, for example, the deficiency of a system based merely on individual remedies subsequently led to the adoption of a collective bankruptcy procedure from the 13th century onwards.¹¹

⁴ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-6 et. seq.

⁵ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-8 et. seq.

⁶ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-13.

⁷ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-9.

⁸ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-15 et. seq.

⁹ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-21 et. seq.

¹⁰ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-31 et. seq.

¹¹ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-38; Kilpi, *The Ethics of Bankruptcy*, p. 10.

In Sweden, a practice similar to the *cessio bonorum* can be perceived in medieval times, mainly in the developing merchant cities, and it was in fact the predominant policy for a long time. The debtor's relief was further developed and culminated in the early 1700's. An Act from 1734 thus provided for a composition procedure as well as for a lengthy moratorium.¹² The initiation of insolvency proceedings was subject to the debtor's prerogative only, and – perhaps a symbol of Swedish legal tardiness – this did not change until a new Bankruptcy Act was passed in 1818.¹³ Due primarily to efficiency drawbacks it was however still out-of-date, and in 1862 it was replaced by yet another Bankruptcy Act. As elsewhere in Europe, French influence was strong. Consequently, a liquidation procedure was introduced and its purely collective character was clearly emphasised.¹⁴ Through the Bankruptcy Act of 1921 this was still more accentuated (that same year a Preventive Compositions Act was passed as well).¹⁵

In sum, during the 16th-18th centuries, collective regimes (the preferred solution) were gradually co-ordinated with composition procedures.¹⁶ The adopted solutions varied slightly, but generally speaking compositions could be of use in terminating bankruptcy as well as in preventing it. Thus, not only was the debtor's position improved and the complications of bankruptcy proceedings avoided, but time was saved as well. These breeds of compositions did not only provide a relief for the debtor, but were beneficial to the creditors too. The modern insolvency procedure – an efficient debt-collection device – was thereby ultimately established, and was in principle common to all the countries of Europe by the end of the 19th century.

2.1.2 *The Rise of a “Rescue Culture”*

After a period of legal consolidation, during which the French bankruptcy law of 1807 was a significant source of inspiration to other European countries, a major change of course occurred. It came about mainly due to the growth of industry and the accompanying large enterprises. The first really large corporations were the American railroad companies in the late 1800's. Some of these firms did not meet the commercial expectations. Regarding the great financial risks at stake, as well as considering the fact that only individual remedies were available and that piecemeal actions would usually tear apart any going concern value, a practice evolved whereby businesses were informally reorganised through the aid of skilled lawyers.¹⁷ Consequently, when the first federal Bankruptcy Act was passed in 1898 it comprised a forum for debt restructuring, thus codifying practice. According to the 1898 Act the debtor could propose a plan for composition, which a court finally might approve as being in the “best interest of the creditors” (meaning that they would get as much (or more) in return as they would have through an orderly liquidation).¹⁸

¹² Welamson, *Konkursrätt*, p. 10 et. seq.

¹³ Welamson, *Konkursrätt*, p. 12.

¹⁴ Welamson, *Konkursrätt*, p. 14.

¹⁵ Welamson, *Konkursrätt*, p. 16 et. seq.

¹⁶ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-45 et. seq.

¹⁷ Baird, *The Elements of Bankruptcy*, p. 64 et. seq.

¹⁸ Baird, *The Elements of Bankruptcy*, p. 70.

Industry continued to boom, and by the 1930's large corporations dominated commerce. These were to a large extent publicly held, and thus public interests entered the picture together with the notorious Great Depression. Legal action was called upon and a wave of amendments followed, culminating in the so-called Chandler Act of 1938. By generally suspending private executions, the reorganisation procedure was tightened up, now involving even secured creditors.¹⁹ These changes were not to be an isolated event. Rather a “rescue culture”²⁰ was born, a culture that had an attractive force and subsequently surfaced in Europe as well. History suggests, however, that some of the underlying motives for the ensuing changes in Europe were rather different from the ones just accounted for.

The European overhaul started in France in 1967 when a new Insolvency Act was passed. The 1967 Act was explicitly aimed at the survival of enterprises vital to national economy.²¹ Consequently, a potentially lengthy moratorium was (re-) introduced, binding all creditors whether secured or not. Again, the French position inspired and influenced other European countries to adopt similar legal products.

In Germany the legal framework was somewhat elderly at the time. The Bankruptcy Code, originally passed in 1877, was founded on the liberal ideals of the Manchester School. Enterprises with small chances of success were to be sifted out.²² To ameliorate the position of bona fide debtors, a Reorganisation Code was instituted in 1935, but it proved to be a complete failure in forestalling bankruptcy, whether the debtors were pitiful or not. The following debate (in the 1960-70's) was to a large extent centred on the need to reform insolvency legislation so that it would better protect the employees.²³

Back in the United States, due to the various amendments, the 1898 Act was patchy and difficult to grasp. As a result, litigation was frequent and the need for a major reform was increasingly acute.²⁴ In 1978, a comprehensive new piece of federal legislation was passed (Title 11 of the U.S. Code, hereinafter the “American Bankruptcy Code” or “11 U.S.C.”). Its principal aims were to avoid the drawbacks of liquidation, to relieve honest debtors and to provide for expedient and efficient administrative routines.²⁵ As we shall see, the Bankruptcy Code's character of a debtor's safe haven would once more be a source of inspiration to other countries.

Again, the American view was first to surface in France. But not only did the French embrace the debtor-oriented perspective. Indeed, when a new French Insolvency Act was passed in 1985 (hereinafter the “French Insolvency Act”)²⁶ the debtor-friendly profile was actually intensified.²⁷ According to the French Insolvency Act, still in force yet amended, a procedure for judicial reconstruction (“redressement judiciaire”)

¹⁹ Wood, *Principles of International Insolvency*, p. 176.

²⁰ Pertinently labelled by Fletcher, *Insolvency in Private International Law*, p. 4.

²¹ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-64 et. seq.; Wood, *Principles of International Insolvency*, p. 177.

²² Stewart, *Insolvency Code. Act Introducing the Insolvency Code*, p. 8.

²³ Stewart, *Insolvency Code. Act Introducing the Insolvency Code*, p. 9.

²⁴ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-107; Epstein et. al., *Bankruptcy*, p. 733.

²⁵ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-106.

²⁶ Loi n° 85-98 du 25 janvier 1985 relative au redressement et à la liquidation judiciaires des entreprises (Law no. 85-98 of 25th January 1985 relating to the judicial reconstruction and compulsory liquidation of businesses (translation from *Butterworths International Insolvency Laws*, p. 49)).

²⁷ Wood, *Principles of International Insolvency*, p. 8.

was made mandatory, and thus couldn't be leapfrogged in any way. Protecting businesses, employees and employment was – and still is – the explicit purpose of the procedure.²⁸ A remarkable feature is furthermore that the Court can initiate proceedings *ex officio*.²⁹ The French Insolvency Act has since been amended,³⁰ in part restoring the rights of secured creditors. What is more, direct access to the liquidation procedure is now possible in exceptional cases.³¹

English laws regarding insolvency were formally divergent from the rest of Europe for a long time. Certainly there had been a unified bankruptcy and composition procedure since the late 19th century, but it applied to individuals only. Corporate insolvency was dealt with separately (in the Companies Act, originally introduced in 1856). This formal dichotomy was upheld until 1986, when almost all insolvency-related legal material was consolidated through a new Insolvency Act (hereinafter the “English Insolvency Act”).³² But even the English Insolvency Act from 1986 is peculiar in some respects. Not only does the Act comprise a reconstruction procedure – the “Administration Order” – and a scheme for compositions. Remarkable is that the traditional so-called “Receivership” institution is preserved. This remedy is a legal aid in the self-help of secured creditors (whether by a single asset or by a floating charge). The English Insolvency Act thus provides four different legal regimes involving corporate default: The Receivership, the Administration Order, the Liquidation procedure and various kinds of arrangements with creditors (e.g. compositions).³³

The English Administration Order does recognise going concern values, but not in the interest of employees. Instead, the company is saved in the interest of the creditors generally. If the company as such can not be saved, a going concern surplus can be realised through a more advantageous sale of the business (indirectly protecting the public as well).³⁴ On comparison with France, for example, the English Insolvency Act is more of a debt-collection service than a guardian of jobs.

In Sweden various public issues, such as employment, have been subject to debate.³⁵ As a consequence a major legal reform was carried through in 1987, when a new Bankruptcy Act (hereinafter the “Swedish Bankruptcy Act” or “KL”)³⁶ as well as a preventive Composition Act were enacted. One of the goals of the reform was to give the trustee the right to consider public interests during liquidation. Ever since, the Swedish Bankruptcy Act thus provides for a balance of diverse interests, but as a rule the outcome must not be disadvantageous to the creditors.³⁷ The Bankruptcy Act has subsequently been amended on several occasions, but is still in force. The Composition Act has since been superseded by – or rather incorporated into – a reconstruction law.

²⁸ French Insolvency Act, Article 1.

²⁹ French Insolvency Act, Article 4 (3rd paragraph).

³⁰ Loi no 94-475 du 10 juin 1994.

³¹ Rajak et. al., *European Corporate Insolvency*, p. 114; French Insolvency Law, Article 1, as amended.

³² Goode, *Principles of Corporate Insolvency Law*, p. 2.

³³ Rajak et. al., *European Corporate Insolvency*, p. 743 et. seq.

³⁴ Goode, *Principles of Corporate Insolvency Law*, pp. 5 and 9; SOU 1992:113, p. 244.

³⁵ See e.g. Prop. 1986/87:90, pp. 93 et. seq, 111 et. seq. and 262 et. seq.

³⁶ Konkurslag (1987:672). ‘KL’ is the conventional Swedish abbreviation.

³⁷ KL, Ch. 7 § 8 (2nd paragraph).

The Swedish law regarding business reconstruction was enacted September 1, 1996 (hereinafter the “Swedish Reconstruction Act” or “FrekL”).³⁸ It provides for a moratorium, during which actual or financial reconstruction of potentially viable businesses can be accomplished.³⁹ Creditor rights are restricted e.g. through provisions on involuntary compositions. Being a product of international influence,⁴⁰ it is obviously analogous to e.g. the American Bankruptcy Code. The Swedish solution thus comprises two separate regimes – Bankruptcy and Reconstruction – which do not necessarily interact.

The most recent European legal reform in this area is the “Insolvenzordnung” (hereinafter the “German Insolvency Act”)⁴¹ enacted in Germany on January 1, 1999, after several years of preparatory work. This piece of legislation is an appropriate mirror of the developments hitherto, and is admittedly inspired by inter alia the French and the American regimes.⁴² By offering a unified procedure, its primary purpose is to relieve the debtor of his debts through whatever alternative may be the most efficient, reconstruction or liquidation.⁴³ Notably, the procedure can be reversed at any time or in any direction, i.e. from reconstruction to liquidation and vice versa.⁴⁴

2.2 *Ipso Facto Clauses Frequently Outlawed*

In most jurisdictions, the debtor’s estate has a right to abandon burdensome property. Correspondingly, it is often furnished with the power to reject onerous contracts as well. The counterparty’s claim for damages, resulting from such abandonment, is generally treated as unsecured.

If the contract – as it stands – provides for a net benefit on the estate’s behalf, the trustee may often require the performance of a solvent contracting party as well. When the solvent counterparty thus is required to perform, she is usually granted some kind of priority or other assurance of the estate’s performance. These powers, vested in the debtor’s estate, are often mandatory and thus can not be contracted about.⁴⁵

2.2.1 *The American Bankruptcy Code*

According to the American Bankruptcy Code, § 365, the estate can freely reject or assume most so-called “executory contracts”. The term “executory” has caused massive litigation, as well as lengthy discussions among scholars. Recent proposals for legal reform suggest that this prerequisite be abolished.⁴⁶ The functional underpin-

³⁸ Lag (1996:764) om företagsrekonstruktion. ‘FrekL’ is the conventional Swedish abbreviation.

³⁹ Prop. 1995/96:5, pp. 57 and 75 et. seq.

⁴⁰ SOU 1992:113, pp. 197 et. seq. and 319 et. seq.; Prop. 1995/96:5, p. 55.

⁴¹ Insolvenzordnung vom 5. Oktober 1994 (BGB1. I, S. 2866). An English translation can be found in Stewart, *Insolvency Code. Act Introducing the Insolvency Code*.

⁴² Stewart, *Insolvency Code. Act Introducing the Insolvency Code*, p. 16; SOU 1992:113, p. 292.

⁴³ The German Insolvency Code, § 1; SOU 1992:113, p. 292.

⁴⁴ SOU 1992:113, p. 292.

⁴⁵ Wood, *Principles of International Insolvency*, p. 60 et. seq.

⁴⁶ *Reforming the Bankruptcy Code*, p. 129 et. seq.; *Bankruptcy: The Next Twenty Years*, p. 472 et. seq.

nings for such proposals will be extensively dealt with later. For now, we can simply note that most mutually unperformed contracts can in fact be assumed or rejected (§ 365(a)), as can such contracts be assigned to third parties as well (§ 365(f)). Positive carve-outs from the main rule have however been considered necessary, e.g. regarding contracts of a personal character.

All these rights of the estate are mandatory (§365(e)), and can not be excluded or modified through contract. When the American Bankruptcy Code was enacted in 1978, a long common-law tradition of recognising ipso facto clauses was thus superseded by a general statutory ban.

2.2.2 The French Insolvency Act

According to the French Insolvency Act, similar powers are vested in the administrator of the estate (Article 37). Almost without exceptions,⁴⁷ he has the right to require performance of existing contracts, and further the counterparty must perform notwithstanding any prior default on the debtor's behalf.

As in the case of the American Bankruptcy Code, such powers are mandatory. By law, ipso facto clauses are generally nullified, whether providing for a complete opt out or merely modifying positions.⁴⁸ Nota bene, the administrator can partially enter into outstanding contracts, i.e. from the commencement of the proceedings.⁴⁹ These powers are extraordinary indeed (and are admittedly quite compatible with the French insolvency policy). Nevertheless, it seems that French case law also provides for the exclusion of e.g. personal contracts or contracts of trust and confidence.⁵⁰

2.2.3 The German Insolvency Act

As already noted, Germany has recently introduced a whole new Insolvency Act, (the “Insolvenzordnung”). We have also seen that, to a great extent, it is a product of major foreign influence. Accordingly, even the German Insolvency Act contains mandatory rules about the debtor's contracts, all vested in the administrator. § 103 gives him the right to “perform in lieu of the debtor” or “demand performance from the other party”.⁵¹ And as expected, ipso facto clauses are nullified regardless if they restrict or terminate the administrator's rights (§ 119).

2.2.4 The English – Divergent – Position

The English position is no different regarding the estate's initial right to require the performance of solvent counterparties.⁵² In the case of liquidation procedures, how-

⁴⁷ Only employment contracts are excluded. See French Insolvency Act, Article 37 (6th paragraph).

⁴⁸ The wording of the Article being (5th paragraph): “no frustration or termination of the contract”. Translation from *Butterworths International Insolvency Laws*, p. 59.

⁴⁹ SOU 1992:113, p. 287; SOU 1999:1, p. 113.

⁵⁰ Wood, *Principles of International Insolvency*, p. 64 et. seq. (being the standpoint of numerous jurisdictions).

⁵¹ Translation from Stewart, *Insolvency Code. Act Introducing the Insolvency Code*, p. 107.

⁵² Wood, *Principles of International Insolvency*, p. 63; Goode, *Principles of Corporate Insolvency Law*, p. 17.

ever, the liquidator has been given wide powers to disclaim – or abandon – onerous property, expressly including “unprofitable contracts” (English Insolvency Act, section 178(3)(a)). Contracts are thus regarded as a mix of assets and liabilities, and a disclaimer will normally be preceded by an entirely commercial net evaluation by the liquidator.⁵³

But – as a major exception to the European trend – rights acquired prior to liquidation are generally recognised. Thus, the debtor’s assets come with limitations, one of them being the possible contractual right of a solvent counterparty to terminate on the debtor’s insolvency (an ipso facto clause).⁵⁴

2.2.5 *The Swedish Reconstruction Act*

Normally during a Swedish reconstruction, the debtor stays in management. The Swedish Reconstruction Act gives the debtor the right to require the performance of solvent counterparties to outstanding contracts, notwithstanding her own pre-petition delay in paying, and this right of hers cannot be excluded by any ipso facto or other clause in the contract.⁵⁵ Because the starting point is that contracts are left unaffected by the initiation of proceedings, such delay would otherwise motivate a right to cancel on behalf of the counterparty, thus jeopardising instead of facilitating reconstruction.

Regarding bankruptcy, however, there is no similar legislative certainty. On the contrary, the Swedish position vis-à-vis contracts in bankruptcy can not be described as anything less than confused. Some scholars argue that it is a question of creditor equality. If an ipso facto clause were to be upheld, they say, one creditor would in fact be granted priority in the face of others. Others have however embraced the idea that – in the absence of legislation – the trustee’s powers should not exceed those of the debtor. For a more extensive discussion on this topic, together with the appropriate references, see section 3.2.5.

2.3 **Contemporary Law: Alternative Means of Categorisation**

It is clear that the development of large corporations has given rise to repercussions on the community as a whole. In the United States, the alleged solution to this problem is an expedient and efficient insolvency procedure, through which the evils of liquidation are avoided and honest individuals are relieved (the “fresh start” policy).⁵⁶ But in Europe, some of the legal reactions seem to be under significant political influence. On occasion public interests are allowed to intervene in the proceedings to a large extent, and often the overriding goal is to maintain businesses and employment. One may wonder if – in such a heterogeneous world – any consensus regarding insolvency law remains.

⁵³ Goode, *Principles of Corporate Insolvency Law*, p. 49; Rajak et. al., *European Corporate Insolvency*, p. 774.

⁵⁴ Goode, *Principles of Corporate Insolvency Law*, p. 19; Pennington, *Pennington’s Corporate Insolvency Law*, p. 199; SOU 1992:113, p. 253, SOU 1999:1, p. 108.

⁵⁵ FrekL, Chapter 2, § 20.

⁵⁶ Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-105.

2.3.1 *On What We All Agree: The Common Ground of Insolvency Law*

There is universal acceptance of the so-called principle of collectivity.⁵⁷ A debtor is legally obliged to pay her debts. If she does not, the creditors' claims can be legally enforced in different ways, e.g. by individual executions. At some point the debtor will not have enough assets to satisfy all claims, why her creditors will have strong incentives to promptly engage in private execution. This "race" among creditors is commonly acknowledged to be a spoliator of values. Thus collective proceedings are called for. One necessary element of collectivity is that various private actions are barred during the proceedings, thus eliminating the possibility for creditors to engage in a similar race post-petition. Also, all developed jurisdictions provide for some kind of procedural retroactivity, in that various kinds of pre-petition transfers of value can be legally reversed.⁵⁸

If individual execution in principle provides for chronological priority (first-come, first-served), collective proceedings introduce a different perspective. If the debtor's assets do not exceed or correspond to her debts, some kind of distribution policy must be developed. On a comparative basis, the common ideology is one of creditor equality. If the debtor's assets do not suffice, the creditors are to be paid proportionally (or *pro rata*) so that everyone loses as much. This is the so-called *pari passu* principle. This principle, however, is not honoured anywhere. On the contrary, all legal systems provide for some kind of parallel priority system, e.g. enabling creditors to effectively secure their claims.⁵⁹

In sum, the common denominator is a collective liquidation regime, accumulating all the assets of the debtor into a common "pool" and after which a coerced sale will take place. The proceeds are thereafter distributed to the creditors according to legally established pre-bankruptcy rights, rights that are to be regarded as positive carve-outs from a basic notion of creditor equality. Previously it has been shown that this concept is firmly rooted in history.

2.3.2 *Insolvency Law From a Debtor-Creditor Perspective*

From a superficial point of view, contemporary insolvency regimes seem to be moving in the same direction. Liquidation concepts are quite similar throughout the world, as is the trend to adopt – and incorporate – reconstruction laws. But just like the various rationales for rehabilitating debtors are politically anchored, liquidation regimes offer splendid mirrors of "the very wellsprings of policy and legal order" in different jurisdictions.⁶⁰

Insolvency law inevitably does involve a wide variety of interests created through other bodies of law. Since there is usually not enough to go around, not all creditors

⁵⁷ See e.g. Epstein et. al., *Bankruptcy*, p. 2; Fletcher, *Insolvency in Private International Law*, p. 8 et. seq.; Jackson, *The Logic and Limits of Bankruptcy Law*, p. 3 et. seq.; Kilpi, *The Ethics of Bankruptcy*, p. 13; Welamson, *Konkurs*, p. 14; Wood, *Principles of International Insolvency*, p. 2.

⁵⁸ Wood, *Principles of International Insolvency*, p. 72 et. seq.

⁵⁹ Fletcher, *Insolvency in Private International Law*, p. 8; Lennander, *Den nya insolvensrätten*, p. 578 et. seq.; SOU 1999:1, p. 86 et. seq.; Wood, *Principles of International Insolvency*, pp. 2 and 10 et. seq.; Welamson, *Konkurs*, p. 14.

⁶⁰ Fletcher, *Insolvency in Private International Law*, p. 4.

can be fully satisfied. And as we have seen, certain creditors are commonly given priority at the expense of others. There is however no consensus regarding whose position should be preferred and whose should be deferred. On a comparative level of some detail the dissimilarities surface.

Extensive comparative research has charted different policies in the international community regarding treatment of creditors, scaling jurisdictions from being “pro-creditor” to being “pro-debtor”.⁶¹ For instance, the respect for ownership and different kinds of security varies. Common law jurisdictions frequently embrace the concept of the trust (protecting secret owners), whereas civil law jurisdictions often hold a “false wealth” ideology (instead sustaining ostensible ownership).⁶² Not only do the attitudes towards ownership differ. In England, secured creditors are in a very strong position while conversely in France they are frequently expropriated in the interest of safeguarding employees.⁶³ Between these two extremes some countries have a more subtle (or confused?) approach, respecting some securities but not others. These considerations are often anchored in the “false wealth” doctrine, mainly upholding legally founded and public securities but at the same time deferring quasi-security transactions such as sales and leaseback or retention of title clauses.⁶⁴

Other elements to consider in this context are e.g. the severity of statutes regarding debtor rehabilitation. Or the harshness of rules regarding the potential avoidance of pre-petition transfers or the abandoning of property. Another parameter concerns the legal readiness to hold persons other than a company liable upon default (piercing the veil of incorporation). Again, the English and French positions are frequently and diametrically opposed, leaving the middle ground open for different approaches.⁶⁵ There are exceptions to this tentative polarisation, however. For instance, the American reconstruction and avoidance rules are among the toughest in the world (i.e. the most debtor-friendly), surpassing even French statutes.⁶⁶

Finally, legal inclination to nullify *ipso facto* clauses is an important aspect of the comparative assessment regarding debtor-creditor attitudes in different jurisdictions. Leaving England aside, the respect for contract seems to be on the decrease.

2.3.3 *Insolvency Law as a Reflector of Public Policy*

As we have seen, the gradual development of reconstruction concepts has led other interests to enter the picture. There has been a shift in debate, from an ideological perspective. Debtor and creditor interests are argued not to be the only ones requiring insolvency assessment. Societal interests, particularly those of employees, have been held to be just as relevant.⁶⁷ From a legal perspective the French Insolvency Act

⁶¹ The major contribution being Wood, *Principles of International Insolvency*. This monograph is one of six in a series called “Law and Practice of International Finance”.

⁶² Wood, *Principles of International Insolvency*, p. 35 et. seq.

⁶³ The French position is not as extreme since the 1994 amendments, when the position of secured creditors was somewhat improved.

⁶⁴ Wood, *Principles of International Insolvency*, pp. 6 et. seq., 18 et. seq. and 35 et. seq.

⁶⁵ Wood, *Principles of International Insolvency*, pp. 6 et. seq., 72 et. seq., 137 et. seq. and 160 et. seq.

⁶⁶ Wood, *Principles of International Insolvency*, pp. 6 et. seq., 79 et. seq. and 183 et. seq.

⁶⁷ See e.g. Dalhuisen, *Dalhuisen on International Insolvency and Bankruptcy*, p. 1-119; Lennander, *Den nya insolvensrätten*, s. 587 et. seq.; Prop. 1986/87:90, pp. 94 and 111; SOU 1999:1, p. 94; Wood, *Principles of International Insolvency*, p. 175.

is an outstanding example, explicitly providing for the protection of such interests. But even elsewhere third party interests have been in focus of scholarly interest as well as they have influenced legal practice. In the United States, for example, insolvency has been tackled by some with a “dirty, complex, elastic, interconnected view”⁶⁸, arguing that a multitude of interests must be balanced inter se.

2.3.4 The Economics of Insolvency Law

By addressing insolvency law with an eye on human behaviour, all these discussions can be brought together as one. History has shown us a regime with remarkable survival instinct. By forcing creditors to act in a collective manner, they can overcome the problem of co-ordinating their debt collection efforts and thus the destructive impact of individuals racing for assets when insolvency looms is eliminated. Firmly anchored in history, the Law and Economics movement possesses tools for a deepened theoretical approach to contemporary insolvency law.

Among other things, this thesis will prove that the present inclination to provide for special insolvency treatment of some societal interests may run contrary to insolvency policy, as it should be. In fact, it will stress the distinction between matters of procedure and matters of substance, arguing that if the latter are to be respected inside bankruptcy they must first be established outside. It will also provide arguments in favour of ipso facto clauses, thus discussing – from an efficiency perspective – one of many substantive issues. The economic analysis will follow in Part II. But first, let us browse some of the conceptual similarities (and differences) between American and Swedish insolvency law.

⁶⁸ Warren, *Bankruptcy Policy*, p. 92.

3. American and Swedish Insolvency Law: A Brief Comparison

In this part a formal – yet brief – comparison between the American and Swedish insolvency regimes will be made. Its sole purpose is to roughly establish legal similarities and differences, thus enabling us to better grasp the economic arguments from American scholars (who naturally relate to American law). Obviously, Swedish law will be subject to a somewhat closer scrutiny than its American equivalent. After dealing with the two countries one by one, a closing synthesis will follow.

3.1 The United States: One Federal Code⁶⁹

In the United States, insolvency – or “bankruptcy” – is governed by federal (statutory) law. The American Bankruptcy Code (11 U.S.C. §§ 101-1330) contains 7 chapters in all, oddly numbered from 1 through 13. We are concerned mainly with two kinds of procedure, more specifically “liquidation” (Chapter 7) and “reorganisation” (Chapter 11). Chapter 7 and Chapter 11 cases have several rules in common. These rules are found in the first three chapters of the Bankruptcy Code (i.e. chapters 1, 3 and 5), and concern e.g. the initiation of proceedings, the property of the estate, the avoidance of pre-petition transfers and the treatment of the debtor’s contracts. Some of them will be further elaborated in the following.

Different matters of security (in significant parts outside the scope of this essay) are governed mainly by the Uniform Commercial Code (U.C.C.) Article 9, as adopted in all the United States. Since the U.C.C. is not federal law, its application may vary between states. Some rules concerning priority, however, are found in the Bankruptcy Code.

3.1.1 *A Unified Procedure: Debtors and Creditors Can File for Bankruptcy*

According to sections common to Chapter 7 and Chapter 11 cases, proceedings can be divided into “voluntary cases” (§ 301) and “involuntary cases” (§ 303). When the debtor files for bankruptcy relief (a voluntary case), the Bankruptcy Code does not require any proof of insolvency. Conversely, creditors can not – absent the debtor’s consent – initiate bankruptcy proceedings until the debtor is “generally not paying” debts as they become due.⁷⁰ Thus, in involuntary cases, some proof of insolvency must be brought before the court. In cases concerning large corporations, a single creditor usually can not file.⁷¹ The American Bankruptcy Code’s character of a debtor’s relief is further accentuated through the protection against creditors filing for bankruptcy in “bad faith”.⁷² The debtor’s discretion is not without limits, how-

⁶⁹ Research for this part was done primarily by studying legislature and literature. The monographs used were Epstein et. al., *Bankruptcy*, Baird, *The Elements of Bankruptcy* and Wood, *Principles of International Insolvency*. Footnotes will be used only for detailed reference or when detailed arguments so demand.

⁷⁰ 11 U.S.C. § 303(h)(1).

⁷¹ 11 U.S.C. § 303(b).

⁷² 11 U.S.C. § 303(i)(2).

ever, as the court has the power to dismiss or suspend cases when “the interests of creditors and the debtor would be better served” by doing so.⁷³

The applicant will normally choose regime (Chapter 7 or Chapter 11). The debtor can also file for a conversion between the two at any time during the proceedings (§§ 706 and 1112). This prerogative is however moderately circumscribed due to creditor interests. For example, the debtor can not convert a reorganisation (Chapter 11) to a liquidation (Chapter 7) when involuntary relief has initially been ordered.⁷⁴ Furthermore, creditors can in some instances persuade the court to convert the case.⁷⁵

In a Chapter 7 case (liquidation), a trustee will always be appointed. At first the court appoints an “interim trustee”, who can eventually be replaced through a majority vote of certain creditors.⁷⁶ A Chapter 11 case (reorganisation) is different, as a trustee will only be appointed under special circumstances (§ 1104). Instead, as a rule, the debtor will continue to operate (as a so-called debtor in possession, or “DIP”). She is then furnished with the same rights, powers and duties as a trustee (§ 1107).

3.1.2 Property of the Estate. Avoidance and Abandonment Powers

To facilitate an orderly administration, a petition for relief under the Bankruptcy Code automatically triggers a pooling of assets. An estate is accordingly created, comprising all the debtor’s “legal or equitable interests /.../ in property” (§ 541). All property interests that the creditors could have reached by individual actions outside bankruptcy are included, i.e. even future income. These interests however come with all the limitations that non-bankruptcy law impose on the debtor.⁷⁷

Since the debtor’s financial situation usually will gradually deteriorate, creditors might take advantage of pre-petition information regarding financial difficulties. To promote the common interest of all creditors, the Bankruptcy Code provides the trustee (or DIP) with powers to avoid (i.e. reverse) certain transfers of property made by the debtor before proceedings are initiated. To avoid conspiratorial pre-petition conduct, fraudulent transfers or incurring of obligations can be legally reversed (§§ 547-548). Such conduct will be nullified if carried out with distributive intent within one year before the filing of a petition while at the same time leaving the debtor in an awkward financial status.⁷⁸ Furthermore, any transfer can be avoided that improves the position of a creditor and that is made by an insolvent debtor within a pre-petition period of 90 days. That is, if it was not made under ordinary business conditions.⁷⁹ Obviously, transactions that leave the estate with equivalent value can not be called in question.⁸⁰ The value of the estate may be further enhanced. The trustee (or DIP) have the powers to abandon property that is onerous or of insignificant value to the estate (§ 554).

⁷³ 11 U.S.C. § 305(a)(1).

⁷⁴ 11 U.S.C. § 1112(a)(2).

⁷⁵ 11 U.S.C. §§ 706(b) and 1112(b).

⁷⁶ 11 U.S.C. §§ 701-702.

⁷⁷ Baird, *The Elements of Bankruptcy*, p. 94 et. seq. and Epstein et. al., *Bankruptcy*, p. 33 et. seq., both with reference to case law (*Chicago Board of Trade v. Johnson*).

⁷⁸ 11 U.S.C. § 548(a).

⁷⁹ 11 U.S.C. § 547(b) and (c)(2).

⁸⁰ 11 U.S.C. § 547(c)(1)(B) and § 548(a)(2)(A).

In sum, we see that a petition for bankruptcy relief effectively counteracts a potential race among creditors, and that private creditor efforts to obstruct the pooling of assets are circumscribed in different ways.

3.1.3 *The Automatic Stay*

Because insolvency administration takes time, there is a need to effectively suspend individual creditors' collection efforts during the proceedings as well. Otherwise, the desired effect of putting an end to the creditor race will not be accomplished.⁸¹ The Bankruptcy Code does just that, in that it triggers a so-called "automatic stay" on creditor actions (§ 362). Roughly speaking, all collection efforts are automatically suspended at the petition for bankruptcy relief, hence the name.⁸² There are some – however few and narrow – exceptions to the main rule.⁸³ Occasionally the stay can be lifted, e.g. when a secured creditor's collateral is not necessary for the debtor's reorganisation or when the debtor is damaging the property in question.⁸⁴ But the main impression remains intact: The automatic stay is wide and comprehensive.

3.1.4 *The Distribution Scheme*

Following liquidation, the proceeds will be distributed among the diverse creditors. As already mentioned, the *pari passu* principle is primarily of theoretical interest. In practice, no creditors are treated on equal footing.

Secured creditors are given "super-priority" and their interests are accordingly excluded from the bankruptcy estate. Security interests are created through a widely admired non-bankruptcy legal product. Substance prevailing over form, Article 9 of the Uniform Commercial Code applies to all security interests, whether traditional ones or transactions with a quasi-security character.⁸⁵ Nota bene, even universal business securities (sometimes called "floating charges") are comprised. The complex rules regarding attachment and perfection of security interests will not be dealt with extensively in this thesis. For now, we will only note that creditors holding security interests supersede all unsecured claimants. The only consequences that they will suffer are the effects of the previously described automatic stay (i.e. they will normally have to wait for proceeds).

After secured creditors have been satisfied, the Bankruptcy Code contains rules regarding priority and distribution (mainly §§ 503, 507 and 726). The highest priority – ranking just below the secured claims – is given to the so-called administrative expenses, i.e. the "actual, necessary costs and expenses of preserving the estate", frequently extended to unsecured debts incurred by the trustee (or DIP) in the ordinary course of business after the commencement of the case.⁸⁶ Other claims that are given

⁸¹ Baird, *The Elements of Bankruptcy*, p. 193; Epstein et. al., *Bankruptcy*, p. 59.

⁸² 11 U.S.C. § 362(a).

⁸³ 11 U.S.C. § 362(b).

⁸⁴ 11 U.S.C. § 362(d)(1) and (d)(2)(B).

⁸⁵ U.C.C. § 9-102(1)(a).

⁸⁶ 11 U.S.C. §§ 364(a), 503(b)(1)(A) and 507(a)(1). The quote from § 503(b)(1)(A).

priority are e.g. certain claims by the debtor’s employees and the tax authorities (in the said order).⁸⁷

Finally, creditors with no priority will receive what might possibly be left over, sharing *pro rata* (i.e. proportionally).⁸⁸ Being the only true *pari passu* creditors, they will generally receive little or nothing.

3.1.5 *Executory Contracts Revisited*

We have already seen that in the United States, so-called “executory” contracts are subject to mandatory bankruptcy rules. According to the Bankruptcy Code, the trustee can – with few exceptions – freely assume or reject such contracts, and even assign them to third parties as well (§§ 365(a) and 365(f)). The said provision is equally applicable regardless of procedure, i.e. in reorganisations as well as in liquidations.

One of the most noteworthy exceptions from the aforesaid powers is perhaps the one in § 365(c)(1), stating that duties that cannot be otherwise assigned cannot be assumed or assigned in bankruptcy either. A salient example of non-assignability is when the performance in question is of a personal character, like e.g. the contractual duty of a prominent singer or actor.⁸⁹ A solvent counterparty to a contract with Madonna should not have to accept the performance of the not so brilliant average trustee.

Another exception is worth mentioning. Due to controversial case law, Congress has seen fit to protect licensees of intellectual property from the rejection of a bankrupt licensor (§ 365(n)).⁹⁰ According to the said provision, upon the licensor’s bankruptcy, a licensee of intellectual property has two options. Either she treats the licence as terminated and files an unsecured claim. Or – more importantly – she can retain her rights under the agreement, including rights of exclusivity, thus ruling out the possibility that the licensor’s estate rejects the agreement.

Apparently the term “executory” is in the melting pot. Instead, American courts tend to emphasise a functional approach, according to which the assessment of contracts in bankruptcy should be based entirely on whether or not the contract in question will enhance the value of the estate.⁹¹ Proposals have also been made that the prerequisite of “executoriness” be abolished, so that the analysis can be functionally streamlined.⁹²

⁸⁷ 11 U.S.C. §§ 507(a)(3-4) and 507(a)(7).

⁸⁸ 11 U.S.C. §§ 726(a)(2 et. seq.) and 726(b).

⁸⁹ Baird, *The Elements of Bankruptcy*, p. 137; Epstein et. al., *Bankruptcy*, p. 256.

⁹⁰ Epstein et. al., *Bankruptcy*, p. 238 et. seq.

⁹¹ *Bankruptcy: The Next Twenty Years*, p. 475.

⁹² *Bankruptcy: The Next Twenty Years*, p. 472 et. seq.; *Reforming the Bankruptcy Code*, p. 129 et. seq.

3.2 The Swedish Position: Two Separate Laws⁹³

Unlike the American Bankruptcy Code – and in fact as opposed to a great number of other modern insolvency laws – Sweden does not have a unified insolvency procedure. Instead, the insolvency regime is split in two separate laws, with two separate areas of application.⁹⁴ The laws in question are the Swedish Bankruptcy Act (KL) and the Swedish Reconstruction Act (FrekL). The former comprises a liquidation regime while the latter's only concerns are financial and actual reconstruction of businesses. Both procedures involve a non-voluntary composition procedure. Other laws with some bearing on insolvency are e.g. the Swedish Seizure Act (UB)⁹⁵ and the Swedish Priority Act (FRL)⁹⁶.

3.2.1 *Two Regimes: Different Prerequisites and Different Prerogatives*

A petition for the liquidation of a debtor may be filed by any creditor as well as by the debtor himself (KL, Ch. 1 § 2). However, an order for the debtor's liquidation will not be given until her financial status has deteriorated to a certain level. According to the Swedish Bankruptcy Act, formal insolvency is a necessary prerequisite. And a debtor is not considered to be insolvent until her financial incapacity is not merely a temporary predicament.⁹⁷

If the debtor herself petitions for bankruptcy, no actual proof of such insolvency is required (KL, Ch. 2 § 7). Conversely, if a creditor files, the starting-point is that she must prove the debtor to be insolvent. Yet, certain presumptions in her favour are granted to somewhat ameliorate her procedural position.⁹⁸ A creditor with adequate security may not file (KL, Ch. 2 § 10).

When the court orders for the debtor's liquidation, she will be dispossessed of her assets and a trustee will be appointed to administer the estate.⁹⁹ The trustee acts on behalf of the creditors as a group, and is expected to promptly wind up the debtor's estate in a profitable manner (KL, Ch. 7 § 8). In that respect, the trustee is generally permitted – but not obliged – to consider societal interests as well (that is when they do not upset the creditors' interests).¹⁰⁰

Both the debtor and her creditors can file for a formal reconstruction of the debtor's business (FrekL, Ch. 2 § 1). The debtor must however approve of a creditor's application, or it will be dismissed.¹⁰¹ If reconstruction proceedings are initiated, the

⁹³ Research for this part was done primarily by studies of legislature and literature. The secondary sources used were Hästad, *Sakrätt avseende lös egendom*, Gregow, *Utsökningsrätt*, Welamson, *Konkurs*, Wood, *Principles of International Insolvency* and Prop. 1995/96:5. Footnotes will be used only for detailed reference or when detailed arguments so demand.

⁹⁴ In fact, the Swedish insolvency regime can be argued to comprise three separate laws, including a law giving pitiful individual debtors the right to a discharge under certain conditions. But since our concerns are restricted to corporate insolvency, the said law falls outside the scope of this thesis.

⁹⁵ Utsökningsbalk (1981:774). 'UB' is the conventional Swedish abbreviation.

⁹⁶ Förmånsrättslag (1979:979). 'FRL' is the conventional Swedish abbreviation.

⁹⁷ KL, Ch. 1 § 2 (2nd paragraph).

⁹⁸ KL, Ch. 2 §§ 8-9; Welamson, *Konkurs*, p. 29 et. seq.

⁹⁹ KL, Ch. 1 § 1, Ch. 1 § 3 and Ch. 3 § 1.

¹⁰⁰ KL, Ch. 7 § 8 (2nd paragraph).

¹⁰¹ FrekL, Ch. 2 § 6 (3rd paragraph) and § 9 (2nd paragraph).

debtor continues to operate the business. An administrator will nevertheless be appointed (FrekL, Ch. 2 § 10). His task is to provide the debtor with professional advice and help her to present a so-called reconstruction plan, while at the same time looking out for the creditors' rights.¹⁰² It should be stressed that the administrator does not operate in lieu of the debtor, even if she is obliged to follow his recommendations.¹⁰³ By way of exception, however, the administrator has been vested with independent powers to avoid certain pre-petition transactions.¹⁰⁴

A reconstruction order is subject to some prerequisites (FrekL, Ch. 2 § 6). A request will not be granted unless the debtor's financial status is in a state of what might be called "anticipatory illiquidity".¹⁰⁵ The law does not prescribe this term, but rather refers to a situation where the debtor presumably will not be able – now or in the immediate future – to pay her debts as due. Neither will the petition be allowed if the achievement of financial or actual reconstruction can not reasonably be expected.

Regarding possible interaction between the two regimes, we can note that the debtor has the main prerogative to choose. If she is engaged in a formal reconstruction, a creditor motion for liquidation will be temporarily suspended (KL, Ch. 2 § 10 a). And if the debtor chooses to file for liquidation, a creditor motion for reconstruction will be dismissed (FrekL, Ch. 2 § 9). Furthermore, a reconstruction case actually in progress will be terminated if liquidation proceedings are instituted (FrekL, Ch. 4 § 7 (2nd paragraph)). Thus, it is only when a debtor is insolvent but not engaged in formal reconstruction efforts that creditors can independently launch liquidation proceedings. Moreover, a case can not be converted from liquidation to reconstruction.

3.2.2 *Property of the Estate. Avoidance and Abandonment Powers*

According to the Swedish Bankruptcy Act, all the debtor's assets that could have been individually seized belong to the estate (KL, Ch. 3 § 3). Under non-bankruptcy debt collection law, as a starting point, all assets can potentially be seized, including intangible assets such as monetary claims, usufructs, patents and the like (UB, Ch. 4 § 2).¹⁰⁶ Yet some exceptions have been considered necessary. For example, property can not be seized if, under certain circumstances, it may not be assigned to third parties (UB, Ch. 5 § 5).¹⁰⁷

In bankruptcy, as in reconstruction, pre-petition transactions may be reversed in order to give the proceedings a retroactive effect. This way, a last minute "grab" race among the creditors can be avoided, and the benefits of a collective regime will not be undermined. The Swedish rules on avoidance are found in the Bankruptcy Act, but are equally applicable when a reconstruction procedure includes a non-voluntary composition (FrekL, Ch. 3 § 5 et. seq.).

¹⁰² FrekL, Ch. 1 § 2 and Ch. 2 § 12.

¹⁰³ FrekL, Ch. 2 §§ 14 et. seq.; Prop. 1995/96:5, p. 58.

¹⁰⁴ FrekL, Ch. 3 § 6 et. seq.

¹⁰⁵ Welamson, *Konkurs*, p. 211.

¹⁰⁶ Gregow, *Utsökningsrätt*, p. 96 et. seq.

¹⁰⁷ Commonly, in Sweden as elsewhere, the private sphere of an individual debtor is protected to some extent. Thus, some assets – arguably important for the household and support of the debtor and his family – are exempted, as are some assets of a personal character (UB, Ch. 5 §§ 1 and 6 et. seq.). Since the main concern of this thesis is corporate bankruptcy, these exceptions will not be further dealt with.

According to the Bankruptcy Act, Ch. 4 § 5, any conduct by the debtor – within a pre-petition period of five years (the “suspect period”) – may be questioned, that either improves the position of any one creditor to the detriment of others or generally impairs the position of the creditors as a group. Furthermore, the conduct in question must have contributed to the debtor’s insolvency and also the counterparty must be believed to have had knowledge of the aggravating circumstances, otherwise the transaction will not be nullified. To not render avoidance impossible or difficult, supplementary rules are given as well. By way of example, a gift completed within a six-month suspect period is voidable, regardless of insolvency (KL, Ch. 4 § 6). As is a payment of debt within a pre-petition period of three months, when “made by an unusual method of payment, in advance or in an amount which causes the debtor’s financial situation to deteriorate considerably” (KL, Ch. 4 § 10).¹⁰⁸ A security that has been established within a suspect period of three months can also be reversed, if it was not a condition when debt was incurred or if the debtor was late in handing it over (KL, Ch. 4 § 12). Furthermore, any priority can be nullified that has been obtained through seizure within three months pre-petition (KL, Ch. 4 § 13). In all cases, the suspect period is significantly prolonged when the counterparty is closely connected to the debtor by kinship or communion.

In Sweden, the partial absence of legal rules regarding abandonment powers has caused some debate. The prevailing view, however, is that such abandonment is legally acknowledged, and an abandonment doctrine is definitely espoused by bankruptcy practitioners.¹⁰⁹ It has even been held that onerous property is not in fact of such character that it should be regarded as property of the estate. Instead, various laws are said to imply that the trustee must actively take over such property for it to be included (“passive abandonment”).¹¹⁰ The latter argument seemingly has some support in UB, Ch. 4 § 3, which allows legal seizure only when a coerced sale will lead to proceeds somewhat exceeding the costs of execution. If – and only if – property can be seized, will it be included in the estate (KL, Ch. 3 § 3).

In Sweden, the purpose of a formal reconstruction is to provide the debtor with a moratorium, thus enabling her – with professional assistance – to reach an agreement with her creditors on how to continue with her business. The debtor is not dispossessed. Instead, FrekL merely enacts a formal suspension of payments while at the same time protecting the debtor’s assets by barring creditor actions and by requiring her to seek the administrator’s advice under certain circumstances.¹¹¹ Consequently, a discussion regarding “property of the estate” during reconstruction proceedings would be somewhat out of place.

3.2.3 Stay on Private Enforcement

According to the Swedish Bankruptcy Act, private executions on the debtor’s property are automatically suspended when the court decides to initiate a liquidation procedure (KL, Ch. 3 § 7). A similar solution is provided for in the Reconstruction Act

¹⁰⁸ Translation from Wood, *Principles of International Insolvency*, p. 132 et. seq.

¹⁰⁹ See e.g. Hästad, *Sakrätt avseende lös egendom*, p. 427 et. seq. and *Insolvensrättsligt forum 22-23 januari 1997*, p. 58 et. seq. (especially pp. 94 and 98).

¹¹⁰ Berglund, *Något om abandonering av konkursgäldenärens egendom*, p. 45 et. seq.

¹¹¹ FrekL, Ch. 2 § 15; Prop. 1995/96:5, p. 83.

(FrekL, Ch. 2 § 17). One important aspect is however that creditors that hold pledges in the debtor's property can enforce their rights, notwithstanding the Swedish "stay". And this regardless of what kind of procedure is initiated.¹¹² Only in exceptional cases – and only in bankruptcy – will they be required to participate in the proceedings (the main reason being that collective weal so requires).¹¹³

Nota bene, the "stay" is not enacted until proceedings are actually in progress. In theory this might pose a problem, since in reconstruction as well as in bankruptcy the court's decision – which formally constitutes the initiation of proceedings – may be delayed due to different circumstances. Yet, creditors will have little to gain from actions in the gap period thus provided, due to the trustee's powers of avoidance.

Finally, as already noted, a creditor application under the Bankruptcy Act will be temporarily suspended when reconstruction is in progress. This can also be seen as a kind of "stay" on creditor actions.

3.2.4 *The Distribution Scheme*

Security interests are generally created according to non-bankruptcy law, but the relevant Swedish statutes are not legally assembled in any way. On the contrary, relevant sections can be found in a myriad of places throughout Swedish legislation and case law. Security interests may be classified as having a "priority" or a "proprietary" character. In the former but not in the latter case will the property covered by a security interest be included in the estate.

We have seen how some property belongs to the estate, while some does not. When the debtor is not the owner (truly or according to the "false wealth" doctrine), someone else apparently "separate" the property in question. Case law further suggests that some kinds of "quasi-security" be legally recognised. For example, retention of title clauses are occasionally respected.¹¹⁴ Similarly, debtors can sometimes escape the tiresome requirement of handing over tangibles when using them as securities. Instead, these assets can be "sold" according to a law dating back to 1845, while in reality serving as a pledge and at the same time leaving the debtor in possession (a so-called "security-sale").¹¹⁵

Other separatists are creditors holding pledges in the debtor's assets. Such creditors are entitled to realise the collateral themselves, but first after giving the trustee the option of honouring their claim (KL, Ch. 8 § 10). Recall even that such creditors can not initiate bankruptcy, unless their security is inadequate (KL, Ch. 2 § 10). They thus stand outside bankruptcy. This applies not only to conventional possessory pledges, but also to those that legally are on an equal footing. For example, according to the

¹¹² FrekL, Ch. 2 § 17; KL, Ch. 3 § 7 (2nd paragraph).

¹¹³ KL, Ch. 3 § 8 (2nd paragraph).

¹¹⁴ Hästad, *Sakrätt avseende lös egendom*, p. 182 et. seq.

¹¹⁵ Lag (1845:50 s 1) om handel med lösören, som köparen låter i säljarens vård kvarbliva. See also Hästad, *Sakrätt avseende lös egendom*, pp. 217 and 294.

Swedish Patent Act (PatL)¹¹⁶ and the Swedish Trademark Act (VML)¹¹⁷, securities in patents or trademarks are to be treated as such.¹¹⁸

When the separatists have been satisfied and the estate thus is established, the remuneration of the trustee will supersede all. According to the Bankruptcy Act, these “bankruptcy expenses” will be paid even before the debts incurred by the estate after the commencement of the case, which thus come next in priority (KL, Ch. 14 §§ 1-2). First after satisfying the two aforesaid groups, the law provides for a distribution of proceeds among pre-petition creditors (KL, Ch. 11 § 1). That is, creditors with security interests of a priority character.

The Swedish Priority Act (FRL) creates a legal priority order, according to which pre-petition claims should be satisfied. Some priorities are equally valid upon seizure as they are in bankruptcy (“special priorities”), whereas others can be enforced only in the latter case (“general priorities”).¹¹⁹ By way of example, FRL grants special priority (that is after the bankruptcy administrator and the post-commencement creditors) to creditors with a floating charge and thereafter to those with an execution order. Being mere “bankruptcy privileges”, additional priority rights follow. Worth mentioning in this context is e.g. the remuneration for a reconstruction administrator (who has evidently failed, since the business is being liquidated). His claims will occasionally supersede even some of the special priority rights with regards to certain property.¹²⁰ Debts incurred during a prior reconstruction procedure enjoy similar bankruptcy priority.¹²¹ Tax claims and employee claims for salaries come next in line, in the said order.¹²²

When the priority order is exhausted, and if there is anything left to distribute, the remaining creditors share the proceeds *pro rata* (FRL, §§ 1 and 18). Thus, in Sweden as elsewhere, the original maxim of creditor equality is reduced to being merely a theoretical by-product.

3.2.5 *The Debtors’ Contracts: An Area of Some Confusion*

In Sweden, the right for the bankruptcy estate to enter the debtor’s outstanding contracts is only codified here and there, mainly in a contractual context and in relation to certain kinds of contracts and situations.¹²³ With respect to many situations, legislation is absent. None of the existing provisions comprising a right of entry are explicitly mandatory. Due to this non-uniform and inadequate legal basis for treating contracts in bankruptcy, the matter has been subject to some scholarly debate. The first extensive effort to grapple the problem of bankruptcy’s impact on contractual relationships was undertaken in 1976. After considering some contractual approaches as well as some bankruptcy-related aspects, apparently no conclusive standpoints

¹¹⁶ Patentlag (1967:837). “PatL” is the conventional Swedish abbreviation.

¹¹⁷ Varumärkeslag (1960:644). “VML” is the conventional Swedish abbreviation.

¹¹⁸ PatL, § 102; VML, § 34 i.

¹¹⁹ FRL, § 2.

¹²⁰ FRL §§ 10(2) and 15.

¹²¹ FRL, § 10(4).

¹²² FRL, §§ 11-12.

¹²³ See e.g. the Swedish Sale of Goods Act (Köplag (1990:931)), § 63, relating to only outright *sales of goods*.

could be established.¹²⁴ The issue was far too complicated. Since then, no certainty has surfaced. Rather, most scholars argue that the obscurity in this area is troublesome indeed, and that legislative measures are of need.¹²⁵

What can possibly be said about the theoretical accomplishment so far is that the disparate statutes express that the estate does have a general right – by way of analogy – to enter all the debtor’s contractual relationships, notwithstanding the partial absence of codification.¹²⁶ The estate’s right to enter comes with certain features, features that furthermore are common to most developed jurisdictions. First, the estate is not obliged to enter into the debtor’s contractual relationships. Rather, they can be disclaimed, or abandoned, and the solvent counterparties will have to claim for damages on an unsecured basis.¹²⁷ Secondly, the estate cannot call for the counterparty’s performance without performing herself (or providing adequate security for future performance).¹²⁸ And finally, the estate’s rights to abandon contracts or require the other’s performance are subject to one major exception: Contracts must be dealt with in their entirety. They cannot be partially abandoned or entered into.¹²⁹

The discussion becomes more intriguing when closing in on whether the estate’s right to enter the debtor’s contracts is mandatory or not. Here, the different arguments can be roughly structured along the lines of an intellectual dichotomy,¹³⁰ according to which one basic outlook is that estate maximisation does call for a mandatory right. On the other hand, an opposite view holds that the estate should not be furnished with better rights than those of the debtor.

The dominating standpoint (heavily influenced by the international position) is that the estate’s right can not be waived in any way. Even if the relevant statute *per se* can be contracted about, the underlying principle is argued to be of a mandatory bankruptcy character.¹³¹ According to this view, bankruptcy’s main purpose is to safeguard the creditors as a group, i.e. maximise the value of the estate. The debtor should not be able to contract about their rights. Being third parties, the argument goes, the creditors are not able to consent to the agreed conditions. They are the only ones succumbing under *ipso facto* clauses and thus the debtor does not have any reason to refrain from offering them. Rather she might actually profit from doing so, since it may lead to her obtaining better deals (e.g. lower prices or lower interest rates). As a consequence, such a clause – being excessively beneficial to only one creditor, while at the same time being to the detriment of all the others – should be banned.

¹²⁴ Hellner, *Verkan av insolvens på kontraktsförhållanden*, p. 249.

¹²⁵ See e.g. Hästad, *Sakrätt avseende lös egendom*, p. 401; Möller, *Konkurs och kontrakt*, p. 828 et. seq.

¹²⁶ Except for when the debtor’s performance is of a personal character. See Möller, *Konkurs och kontrakt*, p. 821.

¹²⁷ Berglund, *Något om abandonering av konkursgäldenärens egendom*, p. 42; Möller, *Konkurs och kontrakt*, p. 40; Wood, *Principles of International Insolvency*, p. 61.

¹²⁸ Möller, *Konkurs och kontrakt*, p. 58; Wood, *Principles of International Insolvency*, p. 63.

¹²⁹ Hästad, *Sakrätt avseende lös egendom*, p. 409 et. seq.; Wood, *Principles of International Insolvency*, p. 62.

¹³⁰ According to Hellner, *Konkursboets inträde i gäldenärens avtal*, p. 197 and Hästad, *Sakrätt avseende lös egendom*, p. 401 et. seq.

¹³¹ See to the following Hästad, *Sakrätt avseende lös egendom*, p. 404; Möller, *Civilrätten vid finansiell leasing* p. 138 et. seq.; Möller, *Konkurs och kontrakt*, p. 71 et. seq.; Möller, *Konkursboets inträde i gäldenärens avtal*, p. 181.

The dominating view is however not uncontested.¹³² Some scholars have argued that such an order creates perverse incentives, because if the estate has a better right than the debtor, rational counterparties will have every reason to reject the contract before bankruptcy proceedings are initiated. Furthermore, they say, the plausibility of pre-bankruptcy settlements will be impaired. It has even been held that the estate will enter into contracts when it is to the benefit of both parties, regardless the legal position. The latter view is based on economic arguments (the Coase theorem), and will find some support in this thesis. Indeed, the opponents' standpoint seems to be the better one.

Unlike in bankruptcy, Swedish reconstruction proceedings do not suffer from legal uncertainty. Ever since the new Swedish Reconstruction Act was passed, the reconstructing debtor has the right to require the performance of contracting counterparties' obligations, even if she is in delay with her own performance (FrekL, Ch. 2 § 20 (1st paragraph)).¹³³ This "right of entry" is further a right to enter contracts partially. The debtor need not perform other than her future obligations, and the counterparty's claims regarding previous performance will be included in a consequent composition scheme (2nd paragraph). The debtor's right is mandatory and can not be waived in any way (4th paragraph).

3.3 Synthesis of Comparison

The American regime provides for a unified procedure, whereas, by contrast, the Swedish system is of a dual character. In the United States the prerequisites for initiating bankruptcy are the same, regardless if the preferred solution is to liquidate the firm or to reorganise it. And as a main rule, conversion between the two regimes is allowed. In Sweden, formal conversion between the two independent regimes is not possible, due to different prerequisites as well as different prerogatives.

To a large extent, however, the preceding survey is an exposé of conceptual similarities (subject to some variance in detail). For example, it is common to both jurisdictions that in liquidation proceedings a trustee will be appointed, whereas during rehabilitation efforts the debtor will stay in operation. Furthermore, both jurisdictions comprise similar concepts of what should be regarded as bankruptcy "assets",¹³⁴ as well as they provide powers to avoid certain pre-petition transfers and to abandon burdensome property. In both countries secured creditors stand outside bankruptcy, yet with somewhat limited rights to realise upon their security during the proceedings.¹³⁵ After the separatists thus have been satisfied, administrative expenses and post-commencement claims will be paid before creditors with established priorities. And finally, if there is anything left to the general claimants, they will share on a *pro rata* basis.

¹³² See to the following Hellner, *Konkursboets inträde i gäldenärens avtal*, p. 196 et. seq.; Möller, *Civilrätten vid finansiell leasing* p. 137 et. seq. (structuring the arguments of others).

¹³³ Employees are however excluded (FrekL, Ch. 2 § 20 (6th paragraph)).

¹³⁴ Leaving the problems of 'ostensible ownership' (the 'false wealth' doctrine) aside, that is.

¹³⁵ As a starting point in Sweden, but not in the United States, creditors that hold pledges can realise upon their security notwithstanding the automatic stay. On the other hand, in the United States, such a creditor can occasionally have the stay "lifted", as will the Swedish creditor occasionally be required to participate in the proceedings. On the whole, the American solution probably is somewhat more reluctant to exclude such creditors. But from a conceptual perspective, these differences should not be overstated.

Regarding the bankruptcy treatment of the debtor's contractual relationships, the American position is quite clear. The trustee (or DIP) may assume, reject and assign such contracts, all based on the notion of estate maximisation and creditor equality.

In Sweden, a reconstructing debtor may also (and partially) require contractual continuance, notwithstanding her own pre-petition delay with payment. What is more, she has been vested with a mandatory such power. But regarding Swedish bankruptcies, we have seen that the position is not as clear.

De lege ferenda, some scholars argue that the estate has a right to enter the debtor's contractual relationships and furthermore that such a right is of a mandatory bankruptcy character. Otherwise, they say, the goal of estate maximisation will be jeopardised. On the other hand, some scholars argue that neither does such a right exist (except when provided for by law), nor is it mandatory. Some even hold that the question is one of mere academic interest, since mutually beneficial agreements will be carried out regardless the legal position. This thesis will prove the dominating arguments to be wrong, in that their theoretical foundation (the notion of an estate-creditor conflict) probably is erroneous. Instead it will offer implicit support to the opposing view, holding – from an economic perspective – that ipso facto clauses should in fact be recognised.

PART II: ECONOMIC ANALYSIS OF BANKRUPTCY LAW

4. The Economics of Orderly Liquidation

Now that it has been established that the systems in the United States and Sweden are conceptually similar, at least with regards to liquidation, we can readily embrace the arguments provided by American scholars in the field of Law and Economics. This part will show that history not only serves a positive explanation for the existing bankruptcy laws. It also carries some important normative implications, implications that will shake modern Swedish bankruptcy theory to its foundations. For reasons already given, the analysis in this part will be narrowed to comprise only the Swedish liquidation procedure and its treatment of mutually unperformed contracts.

The debtor's contracts will be subject to close economic scrutiny in chapter 5, as will the bankruptcy treatment of *ipso facto* clauses. Before engaging in such an intellectual escapade, it is however necessary to fully comprehend the bankruptcy procedure as such (or rather its historical and theoretical underpinnings). Thus, this chapter will provide a general and economic survey of Swedish bankruptcy law. The survey will be openly guided by American scholarship, and thus some parallels to the American legal system will be made.

This chapter will hold that orderly liquidation is what creditors prefer. Once their initial incentives to race for assets are circumscribed, they will act as one and thus efficient (i.e. wealth maximising) debt collection will be facilitated. Furthermore, this (mainly procedural) function is argued to be the only one that bankruptcy should serve. If the creditors' original entitlements were to be altered in a bankruptcy setting, the problem that bankruptcy is supposed to solve would surface anew.

4.1 “Grab” Law and the Common Pool Problem

In most developed countries – Sweden being no exception – reluctant debtors can be coerced to pay through the aid of public authorities. If the debtor is unwilling to pay, her assets can be seized. The relevant Swedish provisions in this area are found *inter alia* in the Swedish Seizure Act (UB) and the Swedish Priority Act (FRL).

When a creditor has obtained a public order, she can apply for the authority to execute on the debtor's property and thus satisfy her claim through a coerced sale (UB, Ch. 3 § 1 and Ch. 4 § 1). There are some limitations on what assets can be seized when they belong to an individual debtor, but regarding corporations most assets are accessible to the creditors. As already noted, intangible assets such as monetary claims, usufructs and patents can be seized (UB, Ch. 4 § 2).

UB is a species of what has eloquently been described as “grab law”.¹³⁶ If more than one creditor files for coerced debt collection, the “first-come, first-served” principle will govern the outcome.¹³⁷ This principle is subject to only one transient exception, according to which property occasionally can be seized simultaneously in the interest of several applicants (UB, Ch. 4 § 11) and in which case the creditors will share the

¹³⁶ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 9.

¹³⁷ UB, Ch. 4 § 30 and FRL, § 9 (4th paragraph).

proceeds *pro rata*. But otherwise, the principle remains intact: The first to file will be first in line to satisfaction (FRL, § 9 (4th paragraph)).

From an economic point of view, the system with individual creditor remedies can be described in the terms of a “prisoner’s dilemma” or a “common pool” problem.¹³⁸ Both models rest on similar assumptions: The diverse participants in the game (the creditors) are selfish profit maximisers, while at the same time being unable to make collective decisions. When there are not assets to go around, the individual incentives will undermine the common interests of the group. This collective action problem would not occur if the participants could get together. Instead the plausible outcome would be that they strike a deal providing for total wealth maximisation.

Imagine any limited “pool” of identical assets (100 units). Furthermore, assume that the pool is worth – if kept together – a monetary amount of \$1000, but that each asset is worth less than its proportionate share (e.g. \$80). Thirdly, imagine a group of 10 individuals with interests in the pool (creditors), each of them entitled to claim \$200. A simple calculation will suggest that five participants can be fully satisfied, while five are left with nothing. Or that each will get an equal dividend of \$100. Since the diverse creditors are not assumed to be altruistic, we would expect the rational behaviour of each individual to be in his self-interest only. If communication within the group is obstructed by facts or costs, and since no one wants to face the risk of being left with nothing, all creditors would engage in a race for the assets, hoping to get full satisfaction. Inevitably, some would win and some would lose. But what is more, since the pool of assets is torn apart by piecemeal action, the total value will not be \$1000, but rather \$800. Thus only four creditors will be satisfied, instead of five. This outcome is clearly inefficient, and the group of creditors – if able to act as one – would presumably have preferred a sale that maximised total wealth.

4.2 The Creditors’ Bargain: A Compulsory Liquidation Regime

History has taught us that civilised bankruptcy law should provide for a compulsory and collective forum, in which multiple creditors can sort out their relative rights. The argument now will be that this is also the preferred solution from an economic perspective.

Bankruptcy law is a reaction to the potential race among creditors. A compulsory collective regime for asset realisation would benefit the creditors as a group. Hence, they would bargain for such a solution *ex ante*, if able or otherwise inclined. But, since co-ordination can not be achieved on account of different circumstances (e.g. transaction costs), such a bargain can not realistically be anticipated.¹³⁹ To promote an efficient outcome, the creditors must be made to act as one. A compulsory bankruptcy regime does just that. Put simply, it provides the *ex ante* agreement that the creditors would hypothetically have made, were they to come together and bargain.¹⁴⁰

The Swedish Bankruptcy Act fills this function. In Sweden, a bankruptcy is an explicit debt-collection procedure, designed as an instrument of all the debtors’ credi-

¹³⁸ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 10 et. seq.; Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules*, p. 402.

¹³⁹ Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors’ Bargain*, p. 44.

¹⁴⁰ Jackson, *The Logic and Limits of Bankruptcy Law*, pp. 12 et. seq. and 17 (note 22).

tors (KL, Ch. 1 § 1). In bankruptcy, the debtor will be dispossessed of her property, which will then be taken care of and sold by a trustee, operating in lieu of the creditors (KL, Ch. 7 § 8).¹⁴¹ After the liquidation, the proceeds will be distributed among the creditors in a predestined order.¹⁴² And even if the trustee is allowed to consider societal interests, as a rule they must not interfere with those of the creditors (KL, Ch. 7 § 8 (2nd paragraph)).

4.2.1 *The Advantages of a Collective Regime*

The advantages of a collective regime are many and obvious. As already noted, assets are often worth more if sold together. A realisation of the “going concern” value – thus aggregating the pie to be divided – is in the interest of the creditors as a group.¹⁴³ But even if this argument is relaxed, there are several others that support the *ex ante* hypothetical creditors’ bargain.

Creditor co-ordination is likely to lead to administrative efficiencies. By replacing disparate individual actions with a collective forum, the total costs will arguably be curtailed.¹⁴⁴

Strategic costs will also lead to long-term inefficiencies, and thus will lessen or diminish the expected dividends of the creditors. In a world without bankruptcy proceedings, not only would creditors probably engage in a race for assets when disaster is imminent (a race that is costly *per se*). Rather, they would incur additional costs while monitoring the debtor and each other, each of them with the aim to forestall the others.¹⁴⁵ Since monitoring efforts presumably will not be unique to only a few creditors, the chances of winning the coming race would probably be very much the same as before (they all know something instead of nothing). From an efficiency point of view, however, the outcome would be costly and thus to the detriment of all.

Furthermore, the creditors would probably be willing to accept a dividend analogous to their relative standing *inter se*. If the choice were to be made between a 50 % chance of getting \$200 (as opposed to nothing) and a guaranteed dividend of \$100, creditors would probably choose the latter alternative. Assuredly, in modern times, risk-averse creditors can diversify (and thus reduce or eliminate) risks by extending credit to several debtors. This argument, however, does not run contrary the notion that they would adhere to a system of guaranteed dividends. Rather it supports it. Diversification is a means to eliminate unavoidable risks. But here the risk can in fact be avoided, and the guaranteed dividend offers a pleasant alternative even to the not so risk-averse.¹⁴⁶

¹⁴¹ See also KL, Ch. 1 §§ 1-3, Ch. 3 § 1 and Ch. 8 § 1.

¹⁴² KL, Ch. 11 § 1 and Ch. 14 §§ 1-2.

¹⁴³ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 14; Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors’ Bargain*, p. 42 et. seq.

¹⁴⁴ Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors’ Bargain*, p. 43 et. seq.; Jackson, *The Logic and Limits of Bankruptcy Law*, p. 16, footnote 20.

¹⁴⁵ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 16.

¹⁴⁶ Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors’ Bargain*, p. 42.

4.2.2 *The Inclusion of Secured Creditors*

At a first glance, unsecured creditors might be thought of as being repellent towards any legal recognition of security. This need not necessarily be. When extending credit on an unsecured basis, a creditor will normally be inclined to charge a higher premium for a higher risk. And conversely, voluntary creditors that are offered security will charge less. The *ex ante* remuneration will mirror the *ex post* risk.¹⁴⁷

Given that the unsecured creditors would not question the presence of security as such, first impressions seem to indicate that creditors holding security do not have any interests in being involved in the bankruptcy proceedings. Thus it may rightly be feared that piecemeal action will obstruct the collectivisation process. But on the other hand, since a collective regime is thought to be an efficient alternative, unsecured creditors will be inclined to compensate those with security. This way, they can be included in the proceedings – improving the collective weal – while at the same time not being left in a worse position than they would otherwise be. And thus the secured creditors are likely not to raise any objections.¹⁴⁸

In sum, there is no conflict between different substantive entitlements outside of bankruptcy, because different creditors will charge for different risks. Also, it is understood that bankruptcy is concerned with deployment decisions only, decisions that are not dependent on distributional standpoints.

4.3 **Creditor Entitlements and Forum Shopping**

This far, the model of a hypothetical creditors' bargain mirrors positive features of most bankruptcy laws, and thus is quite uncontroversial. But it also carries some normative implications, which are not as readily embraced by many. If we have so far explored the logic of bankruptcy law, we are now about to turn to its limits.¹⁴⁹ Not only does the core role of bankruptcy law suggest what it should do, but also what it should not.

4.3.1 *Bankruptcy as a “Nexus of Interests”*

Regard a corporation as a “nexus of contracts”, namely the centre-point of different contracts between a diverse body of investors (stockholders, employees, creditors and so forth).¹⁵⁰ Although corporations are frequently organised so managers have the right incentives when operating the business (i.e. to maximise investor profit),¹⁵¹ firms will inevitably fail for some reason or another. And upon default, the assets of the corporation will not always suffice in satisfying all the various claims.

¹⁴⁷ Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors' Bargain*, p. 44 et. seq. See also Easterbrook et. al., *The Economic Structure of Corporate Law*, pp. 50 and 58.

¹⁴⁸ Jackson, *Bankruptcy, Nonbankruptcy Entitlements, and the Creditors' Bargain*, p. 45.

¹⁴⁹ Hence the title of Jackson, *The Logic and Limits of Bankruptcy Law*.

¹⁵⁰ Bergström et. al., *Aktiebolagets grundproblem*, p. 16; Easterbrook et. al., *The Economic Structure of Corporate Law*, p. 12 et. seq.

¹⁵¹ This can be done by monitoring the managers of the firm ('corporate governance'), or by otherwise creating proper incentives through the choice of capital structure ('corporate finance'). Bergström et. al., *Aktiebolagets grundproblem*, pp. 24 et. seq. and 159 et. seq.

In recent bankruptcy debate, public interests – especially those of employees – have been in the centre of attention. The failure of large corporations and the following unemployment has been an argument for safeguarding the employee’s interests in different ways. In the United States, where a bankrupt business can be operated for years, the rehabilitation of debtors has been argued to be a bankruptcy goal of its own. This way, firms do not necessarily have to fail and as a corollary, the impacts on societal interests are allegedly less severe.¹⁵² Scholars in the field of Law and Economics have challenged this view.

4.3.2 *Strategic Gamesmanship and the Troubles of Transition*

It is true that the failure of a firm will inevitably concern a multitude of interests. When the shareholders find that a company should be dissolved, they commonly have the freedom to do so.¹⁵³ If the company is thought of as better off if a plant is shut down, this can also be done with little or no state intervention.

If shareholders thus choose to cease doing business – partially or totally – interested parties may “suffer” directly, as employees may do when losing their jobs, or indirectly, as other companies may do when commercially dependant on the disappearing company or plant. But the failure of firms must not necessarily be a bad thing, regardless of the aforesaid. Since the shareholders are in constant pursuit for profit-maximisation, the assets of the company will probably be put to better use elsewhere, giving rise to job opportunities and spin-off effects hopefully and totally compensating the initial societal “losses”.¹⁵⁴

If one were to imagine a legal system providing individual creditors with debt-collection remedies (first-come, first-served), while at the same time not offering a supplementary collective proceeding, the various interested parties would still face the risk of companies not being able to pay everyone. In this situation we have seen that self-interested parties would have a powerful incentive to race for assets, so that they will not be left empty-handed. If some creditors have security, and some do not, the situation would be pretty much the same. In this case, however, the only claimants inclined to “race” would be the ones without security, and their incentives in the end depend on whether or not there will be anything left for them. If the assets are likely to satisfy only the secured claimants, the ones without security would be sorry, but yet there would not be any point in incurring costs to chase the unobtainable. But assume that the different claimants were supplied with a collective regime, and assume moreover that this regime alters their priority rights *inter se*. Two illuminating examples will be given to highlight the problems we would then face.

In Sweden, employees are apparently thought of as worth protecting. Accordingly, they are given a special bankruptcy privilege through the Swedish Priority Act (FRL) and the Swedish Wage Guarantee Act (LGL)¹⁵⁵. According to the said laws, the State guarantees certain remuneration inside of bankruptcy, which would not have been provided otherwise, and claims for wages have a priority unique for bankruptcy as

¹⁵² See e.g. Warren, *Bankruptcy Policy*, p. 80 et. seq. and p. 92 et. seq.

¹⁵³ In Sweden this is regulated by Chapter 13 of the Companies Act (Aktiebolagslag (1975:1385)).

¹⁵⁴ Baird, *A World Without Bankruptcy*, p. 32.

¹⁵⁵ Lönegarantilag (1992:497). “LGL” is the conventional Swedish abbreviations.

well.¹⁵⁶ After paying the employees, the State will enter their priority position through subrogation.¹⁵⁷ Since the guarantee – and the priority – are applicable only in bankruptcy proceedings, they evidently create perverse incentives.¹⁵⁸ Put simply, the employees can get full satisfaction inside of bankruptcy, while the same non-bankruptcy outcome would be at the least unlikely. Moreover, in bankruptcy – where the creditors’ interests come first (KL, Ch. 7 § 8) – the State guarantee is a tempting source of extra “funding”. The workers can be used to enhance the value of the estate, thus creating better opportunities for creditors with priority ranking higher than the employees, while at the same time not worsening the position of those ranking lower. This fund is widely used.¹⁵⁹

Another example can be given. In Sweden, tax claims are given a special bankruptcy priority (FRL, § 11). Because the Swedish State is a major creditor, tax claims vis-à-vis companies in financial distress accordingly are proportionally large. If the various claimants were to compete in a non-bankruptcy context, the State would be one of many claimants without security, racing for what may remain after the secured creditors have been satisfied. Unlike the present situation, the fiscal authorities thus would be inclined to participate in efficient reconstruction or composition negotiations.¹⁶⁰ But for now, they will instead seek bankruptcy absolution, regardless what may be in the interest of the group.¹⁶¹

4.3.3 Bankruptcy Law Should Curtail – Not Create – Perverse Incentives

If all this were to be fit into the hitherto advocated theoretical model, the implications would be as follows. Bankruptcy law is a reaction to a common pool problem, enabling the group of creditors to act as one. This way, if the assets are worth more together than if torn apart, going concern values are realised. And at the same time the strategic and administrative costs are curtailed. By realising assets as a sole owner would, the value of the estate is maximised to the benefit of the creditors as a group. If non-bankruptcy entitlements were to be altered upon the initiation of bankruptcy proceedings, some creditors – but not all – would win. The creditor with a bankruptcy advantage would have an incentive to file, even if the creditors as a group would not benefit from formal liquidation. Thus, the individual self-interest of a few would undermine the interests of all, and the fundamental problem of creditor coordination would be reintroduced.¹⁶²

If one were to determine what is – or ought to be – bankruptcy policy in this context, the answer must be that rights created by non-bankruptcy law shall be respected

¹⁵⁶ FRL, § 12 and LGL, §§ 1, 7 and 9.

¹⁵⁷ LGL, § 28.

¹⁵⁸ The following discussion is inspired by Eisenberg, *Creating an Effective Swedish Reconstruction Law*, p. 27 et. seq., Lindskog, *Lönefrågan vid fortsatt rörelsedrift i konkursbo*, p.52 et. seq., SOU 1999:1, Appendix 7, p. 44 et. seq. and Wennberg, *Vem vinner på nya lagen om företagsrekonstruktion? Många kritiska mot staten och bankerna*, p. 12.

¹⁵⁹ Eisenberg, *Creating an Effective Swedish Reconstruction Law*, p. 30.

¹⁶⁰ SOU 1992:113, p. 329 et. seq.; SOU 1999:1, p. 189.

¹⁶¹ A Swedish Committee has proposed several and important changes in the Priority Act (SOU 1999:1), one of them involving the removal of the tax claim priority. As a consequence, the Swedish Justice Department is at present considering possible legislative measures.

¹⁶² Jackson, *The Logic and Limits of Bankruptcy Law*, p. 21.

inside bankruptcy, no more no less. In the United States, the Supreme Court has confirmed this bankruptcy principle. In *Butner v. United States*, they argue that

“Uniform treatment of property interests /.../ serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving “a windfall merely by reason of the happenstance of bankruptcy”.”¹⁶³

Since the argument is that bankruptcy should be regarded as merely an efficient alternative to individual creditor remedies – simply a debt collection device – perverse incentives would be created if bankruptcy were to create rights instead of merely vindicating them. The creation of entitlements unique to bankruptcy is tantamount to giving the entitled creditors special rights to the assets of the estate.¹⁶⁴ If different settings were to provide different rights, some interested parties would obviously have incentives to seek bankruptcy absolution (or “forum shop” if you will).

Thus, bankruptcy should be concerned only with maximising the value of the pool, not with allocating entitlements.¹⁶⁵ Or rather, the latter will inevitably conflict with the former. These conclusions do not necessarily mean that workers – or other interested parties for that matter – are not worth protecting. It only means that if they are worth protecting, they should be protected from firm failure generally, and not treated differently inside bankruptcy than they would have been outside. Distributional concerns should be dealt with on a non-bankruptcy level. They must not influence bankruptcy decisions, however tempting it may be. Issues of social policy are not unique to bankruptcy. But perhaps they are politically less controversial in such a context, since alleged societal interests – e.g. of protecting employees – will not be counteracted to the same extent as in another setting. For example, interests of the industry are more likely to arise in relation to companies that are alive and well.

4.4 Some Features Peculiar to Bankruptcy

The principle established in *Butner v. United States* must be subject to some modification if core role of bankruptcy is not to be jeopardised. All issues arising in bankruptcy must be measured against the collectivisation goal, and sometimes this will in fact require that non-bankruptcy rights be altered. But – as we are about to see – this will only be done to the extent that it benefits the group, or it will bring about collective action problems again.

4.4.1 The Concept of Relative Values

Non-bankruptcy “grab” law gives creditors the right of having their claims specifically enforced. When the debtor is insolvent, all claimants can not be satisfied in such a manner. Thus, a bankruptcy regime must overrule the individual “grab” remedies. Instead, in a bankruptcy setting, the nominal values of the various claims are trans-

¹⁶³ 440 U.S. 48 (1979), p. 54-55.

¹⁶⁴ Baird, *A World Without Bankruptcy*, p. 34.

¹⁶⁵ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 24

formed into relative values.¹⁶⁶ Imagine three creditors that hold identical monetary claims (i.e. to the same amount, say \$300 each), but no security. Furthermore, assume that the debtor's assets do not suffice (they amount to a mere \$300). In this situation, it is highly plausible that the three creditors would agree to be paid \$100 each, since that amount replicates the odds of them getting paid in a race for the assets (one out of three). They would agree to equal (or *pro rata*) treatment, because it would maximise their total return (they would not have to incur costs to monitor each other, engage in a race etc.).

Given the fact that the assignment of non-bankruptcy entitlements does not upset the collectivisation goal, this apportioning rule is equally applicable when different claimants rank differently in priority. The creditors would probably be willing to accept a dividend analogous to their relative standing *inter se*. Or put in other words: If they were able to negotiate *ex ante*, they would still be expected to favour *pro rata* distribution, but within the different classes instead. Again the probability of getting paid would be adequately reflected, and still the different creditors would be able to act as one.¹⁶⁷

General creditors usually get little or nothing in bankruptcy, a fact that is sometimes advocated to be a violation of the principle of creditor equality. Although this standpoint is common, it has nothing to do with the function of bankruptcy. Assigning non-bankruptcy entitlements to such an extent that general creditors are left with scrap does not affect the common pool problem. Creditors, regardless of class, will still file for bankruptcy if – and only if – it is in the interest of the group. We can do away with securities generally, thus enhancing the general dividend, or we can choose to maintain priority order for one reason or another. But this is not a bankruptcy matter.¹⁶⁸

4.4.2 *Nullification of Certain Pre-Bankruptcy Activity*

Insolvency does not come about overnight. Or at least in most cases it does not. Instead, it is more plausible that financial distress, and finally insolvency, is a gradual event. Creditors will – some of them early and others late – gain knowledge of the debtor's predicament, and will react accordingly. The strategic response of the creditors will reintroduce the co-ordination problem: They will engage in a destructive pre-petition race for assets, with the intent to opt out of an impending collective procedure.¹⁶⁹ That is, if bankruptcy law does nothing about it.

All developed bankruptcy laws do however grapple this problem. And the rationale to do so is widely recognised, if not universal.¹⁷⁰ Hitherto we have developed a theoretical framework providing disparate creditors with a compulsory and collective regime. This regime will solve their co-ordination problem and enable them to share proportionally (within classes defined by non-bankruptcy law) the losses that they will inevitably suffer upon the debtor's insolvency. If creditor actions in the “suspect

¹⁶⁶ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 28 et. seq.

¹⁶⁷ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 57 et. seq.; Jackson, *Of Liquidation, Continuation and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules*, p. 404 et. seq.

¹⁶⁸ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 61.

¹⁶⁹ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 122 et. seq.

¹⁷⁰ Wood, *Principles of International Insolvency*, p. 72 et. seq.

period” prior to the commencement of proceedings were to be generally allowed, not only would the distributional order be corrupted. Also, and more importantly, the destructive race for assets would not be eliminated.

In the comparative survey, we have seen that the legal systems in the United States as well as in Sweden provide for the nullification of certain pre-petition transactions. Although there is some variety in detail, the basic concept is the same. A pre-petition race is as destructive as the race following from the initial common pool problem. Since we live in a dynamic world, and because courses of events take time, bankruptcy – to properly fill its function – has to be in part retroactive.¹⁷¹

4.4.3 *Individual Actions Barred During the Procedure*

Not only are bankruptcy procedures the result of a successive financial deterioration. The proceedings themselves take time as well. Thus, the law must avoid giving creditors the option of behaving strategically while the estate is being administered. Again we see that individual self-interest, that will run contrary to the interests of the group, must be discouraged.¹⁷² And so, because proceedings take time, not only must the launch of a bankruptcy proceeding supersede individual actions, it must also ensure that the creditors’ rights of individual enforcement are suspended effectively for as long the procedure is pending. The fact that creditor rights are frozen is a characteristic of bankruptcy law that is practically universal.¹⁷³

Previously, we have seen that the American Bankruptcy Code provides for an “automatic stay” that is very severe. All creditor actions are frozen, starting with the filing of a petition. The Court may occasionally order for the stay to be lifted on behalf of a creditor, but these are exceptional cases indeed.

We have also seen that the Swedish laws offer a similar solution. However, secured creditors are however excluded from the proceedings (by exception from the stay). Is not this incompatible with the collectivisation goal? A closer scrutiny reveals that it need not necessarily be so. First, remember that private seizure for secured creditors may very well be allowed, but may also be temporarily suspended if collective efficiency so requires (KL, Ch. 3 § 8 (2nd paragraph)). Secondly, creditors with possessory pledges may very well realise their security individually, but before doing so they are also obliged to offer the trustee the opportunity to honour their debts (KL, Ch. 8 § 10). Accordingly, going concern values and other advantages of collectivisation may be recovered.¹⁷⁴ We now see that the economic rationale for staying secured creditors’ collection efforts is limited. If the stay does not bring about collective benefits, the secured creditors’ rights should be specifically respected.¹⁷⁵

¹⁷¹ See e.g. Baird, *The Elements of Bankruptcy*, p. 165, Epstein et. al., *Bankruptcy*, p. 278, Hästad, *Sakrätt avseende lös egendom*, p. 267, Jackson, *The Logic and Limits of Bankruptcy Law*, p. 123 et. seq., and Welamson, *Konkurs*, p. 14.

¹⁷² Jackson, *The Logic and Limits of Bankruptcy Law*, p. 151.

¹⁷³ Wood, *Principles of International Insolvency*, p. 2.

¹⁷⁴ Welamson, *Konkurs*, p. 126.

¹⁷⁵ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 151 et. seq.

4.5 Property of the Estate – Assets and Liabilities

Not many legal scholars or practitioners purport that legal labels shall be determinative when solving legal problems. Instead, most support a functional approach, according to which e.g. “ownership” is really just a bundle of legal rights.¹⁷⁶ These rights, or entitlements, come with corresponding liabilities. Owners have rights and others, as a corollary, have obligations. Due to changes in law or agreements entered into, these rights and obligations may further vary in detail and over time.

Any given bundle of rights may or may not have a positive net value. The functional assessment must further be made from a “party-oriented” perspective.¹⁷⁷ For example, any property that may be part of the bankruptcy estate may also be burdened with some kind of security interest. This is a recognised fact. If so, the secured creditor will be satisfied first, and residual claimants will wait in line for leftovers. This is equivalent to saying that any secured creditor has a potential interest in the property in question. To her, it is an “asset”. From the perspective of the debtor, however, it probably will not have a positive net value. To her, it is a “liability”. And if the debtor owns only such property, a bankruptcy procedure will not be initiated. Only when the debtor has assets – or property with a positive net value – will the estate be enhanced, and only in these cases should proceedings be instigated.

This concept of property is of central importance in a bankruptcy setting. Notwithstanding how the legal rules allocate title, or property, the functional concept will be the same. The bankruptcy inquiry thus seems to be rather simple: Assets are of value to the estate and liabilities are not.¹⁷⁸ In fact, thinking this way will help us overcome some of the difficulties hitherto encountered in bankruptcy debate. This concept will furthermore facilitate the bankruptcy treatment of contracts, a matter soon to be encountered (in chapter 5).

It must not be forgotten that the debtor’s property may very well be valuable, but only after someone else’s recognised entitlement has been satisfied. In the United States this principle was established early in a classic case. In *Chicago Board of Trade v. Johnson*,¹⁷⁹ the Supreme Court held that a membership on the Board of Trade could be sold, but only after (according to the rules of the Board) all debts to the other members were paid in full. Thus, only the potential net value was regarded as part of the debtor’s estate. The Supreme Court correctly identified the problem as one of attributes, not of labels (according to non-bankruptcy law, such a membership is not “property”).

This principle seems to hold in Sweden as well. Previously it has been shown that according to Swedish law, all interests that the debtor holds in property can be seized and thus will be included in the debtor’s bankruptcy as well (UB, Ch. 4 § 2 and KL, Ch. 3 § 3). Even more limited rights are comprised, like monetary claims, usufructs,

¹⁷⁶ See e.g. Coase, *The Firm, the Market and the Law*, p. 11 et. seq.; Hästad, *Sakrätt avseende lös egendom*, pp. 19 and 22 et. seq., Gregow, *Utsökningsrätt*, p. 96 et. seq., *Insolvensrättsligt forum 22-23 januari 1997*, pp. 94 and 98, Jackson, *The Logic and Limits of Bankruptcy Law*, p. 91 et. seq. and Lindskog, *Kvittning Om avräkning av privaträttsliga fordringar*, p. 36 et. seq.

¹⁷⁷ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 90.

¹⁷⁸ Jackson, *The Logic and Limits of Bankruptcy Law*, pp. 93 and 99; Jackson, *Translating Assets and Liabilities in the Bankruptcy Forum*, p. 67.

¹⁷⁹ 264 U.S. 1 (1924).

patents and the like. As a main criterion, however, such an interest (apart from being assignable) must have some positive net value (UB, Ch. 4 § 3).¹⁸⁰ Recognised rights of third parties are respected as well.¹⁸¹ Creditors holding ordinary pledges, for example, are assured payment before executing creditors with inferior priority (UB, Ch. 8 § 11). Generally speaking, even creditors holding a floating charge have the same right (UB, Ch. 8 § 13). Retention of title clauses are protected as well (UB, Ch. 9 § 10). And the right to set-off counterclaims is sustained outside bankruptcy as well as inside.¹⁸²

The principle established in *Chicago Board of Trade v. Johnson*, that also appears to be a positive feature of Swedish law, is crucial indeed. Yet it is so easy to forget. Therefore, before encountering the debtor's contracts, it may be appropriate to keep it fresh in mind: The debtor's property may very well be valuable, and thus represent an asset, but only after the recognised entitlements of others have been satisfied.

¹⁸⁰ Gregow, *Utsökningsrätt*, p. 96 et. seq.

¹⁸¹ Gregow, *Utsökningsrätt*, pp. 103 and 217 et. seq.

¹⁸² Lindskog, *Kvitning Om avräkning av privaträttsliga fordringar*, pp. 68 et. seq. and 524 et. seq. Nota bene, the right to set-off is extended in bankruptcy. Even claims that have not matured can be set-off against the estate's claims (KL, Ch. 5 § 15).

5. The “Magic” of Mutually Unperformed Contracts in Bankruptcy

Now that the conceptual framework is finally in place, we will turn to deal with one of many explicit problems that arise in bankruptcy. In all bankruptcies, more or less, the trustee will have to consider how to deal with the debtor’s outstanding contracts. In many jurisdictions we have seen that the estate has a right to reject such contracts, as it will occasionally be entitled to demand the performance of the other party. What is more, bankruptcy laws frequently nullify clauses that permit the solvent counterparty to exit costlessly (so-called ipso facto clauses). In Sweden, such a ban on ipso facto clauses can be found in the Reconstruction Act. With regards to liquidation bankruptcy, however, the Swedish position is unclear, to say the least.

This chapter will not deal in detail with all the arguments that have been brought forward by different scholars. Rather it will provide a downright and fresh examination, built entirely on economic concepts, and thus hopefully will shed some light on the Swedish position. After initially and generally examining the bankruptcy world of contracts, the discussion will come full circle with an economic analysis of the solvent contracting parties’ alleged incentives to opt out of bankruptcy through the use of ipso facto clauses. As in the preceding chapter, the analysis will plunge deep. Indeed, the very foundations of bankruptcy theory will be called in question (as will the dominating Swedish attitude towards ipso facto clauses).

Throughout the analysis, a fictitious license agreement (with the licensee involved in bankruptcy proceedings) will be used to exemplify the otherwise abstract reasoning. These examples are going to be very simplistic, perhaps so simplistic that they will not adequately mirror the complexities of the real world. But on the other hand, they will actually provide us with an appropriate framework for making more complex assessments. One must not forget that the basics, however basic they may be, can sometimes be difficult to comprehend.

5.1 Bankruptcy Treatment of Mutually Unperformed Contracts

If bankruptcy law in general is an area of peculiar fascination, the bankruptcy treatment of contracts is undoubtedly equally intriguing, if not more. This area has a certain kind of “magic” to it, a magic that will easily lead us intellectually astray. As we are about to witness, however, an economic approach – by establishing the necessary conceptual framework – will safely guide us through the deceptive assessments that we have to undertake. And when we are finished, we will see that the difficulties involved do not really lie on a legal, but rather on a contractual, level.

5.1.1 *A Bundle of Rights (Assets) and Obligations (Liabilities)*

All bilateral contracts constitute rights as well as obligations (or assets and liabilities).¹⁸³ Even in the simplest case, like a straightforward sales contract, both parties

¹⁸³ Westbrook, *A Functional Analysis of Executory Contracts*, pp. 231 and 247.

are obliged to perform as well as they are entitled to the other's performance. If one party has already fulfilled her part of the deal but the other has not (e.g. the buyer has paid in advance and awaits delivery), the contract will simply represent an asset and a liability to the two parties, respectively. If the debtor has performed, the contract will be an asset to the estate and conversely it may constitute a liability if the debtor is the one remaining to perform.¹⁸⁴ Here we must recall that the non-debtor parties' rights as a rule can not be specifically enforced vis-à-vis the bankruptcy estate. That is, if they do not hold any security interest or other recognised right in the property concerned.¹⁸⁵

If the contract in question is mutually unperformed, however, the rights and obligations are interdependent, so that no one party – regardless of bankruptcy – can require the performance of the other without performing herself.¹⁸⁶ Furthermore, the duty to perform may be of a monetary or a specific nature. Consider again the simple sales contract (regarding goods). In this case, we have only two obligations, one to pay and one to deliver. And, as a corollary, the same contract contains two rights to remuneration, one monetary and one in kind. These rights and obligations are necessarily intertwined. If the buyer does not pay, the seller can withhold the goods. If the seller does not deliver, the buyer can withhold her payment.

Now let us face reality. Commonly, contracts are not as straightforward as the one previously described. A patent licence agreement, for example, normally contains a multitude of provisions.¹⁸⁷ First, the licensor will provide a right (often exclusively) for the licensee to exploit the patent within certain spheres of application, in a certain territory and during a certain period of time. In return, the licensee will be expected to pay a lump sum and/or royalties. Furthermore, the licence as such is usually merely one component of many in a complex agreement containing inter alia covenants to share present and future know-how, non-competition clauses and bonds of secrecy. And let us not forget the frequent presence of *ipso facto* clauses. Without plunging into details, it is apparent that such a contract will comprise a great deal many more assets and liabilities than the ordinary sales contract.

But the economic perspective remains basically intact. A mutually unperformed contract is still a mix of both assets and liabilities. And by netting out the difference between them, the contract can be seen as a net asset or a net liability.¹⁸⁸ Because the various rights and obligations are interdependent, the trustee's calculation will not be as simple as when determining whether or not to abandon a typewriter found in the debtor's office. But his decision will nevertheless follow the same lines of thought. If the contract is of no net value to the estate (i.e. to the creditors as a group) it should be breached (or abandoned), otherwise not.¹⁸⁹ The trustee will breach the contract, as would the debtor outside bankruptcy, when a breach is more profitable than continued performance.

¹⁸⁴ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 106 et. seq.

¹⁸⁵ Hästad, *Sakrätt avseende lös egendom*, p. 398 et. seq.

¹⁸⁶ Hästad, *Sakrätt avseende lös egendom*, p. 400; Möller, *Konkurs och kontrakt*, p. 56 et. seq. ("den alménska principen"); Westbrook, *A Functional Analysis of Executory Contracts*, p. 247; Wood, *Principles of International Insolvency*, p. 62.

¹⁸⁷ To the following, see Koktvedgaard et. al., *Lärobok i immaterialrätt*, p. 385 et. seq. and Möller, *Konkurs och kontrakt*, p. 576 et. seq.

¹⁸⁸ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 106 et. seq.

¹⁸⁹ Westbrook, *A Functional Analysis of Executory Contracts*, p. 248.

5.1.2 *Expectation Damages and Efficient Breach*

During the course of business, most deals will turn out to be good or bad, depending on different circumstances. Yet contract law requires the debtor in a bad deal to perform, and ensures its enforcement by providing the breached party with a right to expectation damages (hereinafter the “ED” rule). As a consequence, contracting parties have efficient incentives regarding potential breaches of contract. If any one party will gain more from a breach than she will consequently be obliged to pay the other in damages, a breach will be efficient, i.e. increase total economic welfare. And conversely, if the expected damages will exceed her profits from a breach, the contract will remain in force.¹⁹⁰ All costs that will arise from a breach are internalised in the preceding evaluation.

Again, let us picture a patent licence agreement. First, imagine a contract of perfect balance. The obligations of one party are a perfect match to the rights of the other. Or, by way of example, the value of the licensed technology is actually worth the royalty agreed upon (say a total of \$1000). Obviously no party has an incentive to breach. However, in reality, perfectly balanced contracts are unusual. One may easily posit a situation where the licence – due to e.g. market fluctuations, public opinion or the like – is not worth more than \$900. In this situation, a breach would lead to a loss on the licensor’s behalf. She would probably be able to licence the patent to another company, but only to an amount of \$900 (that is if we ignore the costs involved in marketing and negotiations). Under the ED rule, the breaching party would be obliged to pay for her loss, i.e. \$100. Thus no breach would occur, since the licensee would be obliged to pay the same amount (\$1000) either way.

5.1.3 *The “Ratable” Damages Rule and Creditor Equality*

In bankruptcy it is a whole different story. To be sure, general (i.e. unsecured) creditors can not expect to get anything more than a mere dividend if the debtor becomes insolvent. In Sweden, more than 50 % of bankruptcies end up with no surplus whatsoever, and even when they do, the average pay-off to general creditors amount to a mere average of 3-4 % of their original claims.¹⁹¹ This state of affairs is not unique to Sweden, but rather is a universal phenomenon.¹⁹²

Inside bankruptcy, the trustee’s commercial evaluation of the debtor’s contracts will be essentially different from the one made in the world of ED rules. In sharp contrast to the elementary business judgement the debtor would have made in relation to her outstanding contracts, the trustee administering her bankruptcy does not have to evaluate a potential breach on the basis of being liable to pay expectation damages in full. Because the solvent counterparty’s claim will be proportionally down-rated according to the aforesaid, the damages actually awarded will amount to a small dividend (if any) of the initial entitlement. The general creditors will not be paid in the ordinary currency, but in what might be called “Bankruptcy Dollars”,¹⁹³ i.e. the proportionate dividend (3-4 %) of their original claims. Due to this “ratable damages”

¹⁹⁰ Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, p. 530; Mercurio et. al, *Economics and the Law. From Posner to Post-Modernism*, p. 77; Polinsky, *An Introduction to Law and Economics*, p. 33 et. seq.

¹⁹¹ SOU 1999:1, pp. 128 et. seq., 138 and 157.

¹⁹² Wood, *Principles of International Insolvency*, p. 26.

¹⁹³ As aptly put in Westbrook, *A Functional Analysis of Executory Contracts*, p. 253.

rule (hereinafter the “RD” rule),¹⁹⁴ the trustee will want to enter contracts that enhance the value of the estate, and reject those that do not. But as we are about to witness, he will not stop at rejecting the contracts that the debtor would have rejected. And, what is even more important, economic welfare will seemingly be affected.

To fully understand the impact of the RD rule, let us return to the fictitious licence agreement while imagining some different scenarios regarding the today value of the licensed technology.¹⁹⁵ Just like before, assume that the solvent counterparty can license the technology to someone else if the trustee chooses to breach the contract (and suppose once more, however unrealistic it may be, that this can be done without incurring costs of any kind). Furthermore, our example will be built on the assumption that the payout rate to unsecured creditors is 4 %.

With the assumptions thus in place, let us start with the perfectly balanced contract. When the agreed remuneration of \$1000 fully represents the licensed technology’s today value, the trustee clearly will be indifferent as to whether he should reject the contract or not, since in either case the value of the estate will be the same.¹⁹⁶ Neither will it matter to the solvent counterparty, because she could easily reduce her damages to none by offering the license to someone else.

Now ponder that the value of the licence has increased for some reason, meaning that the debtor has in fact made a rather good deal, and that it’s today value is \$1100. In this case the trustee clearly will want to enter the contract, thus enhancing the value of the estate by \$100. And the solvent counterparty will not have any reason to disagree. Rather, she would be happy if the trustee were to breach, since she could then make a nice profit from licensing the technology to someone else. We will return to this situation later, while discussing ipso facto clauses.

Finally let us turn to the situation where the value of the licence has declined. If the licence is actually worth only \$900, but the estate’s performance amounts to \$1000, the trustee will have a strong incentive to breach the contract because of the RD rule. Certainly, the solvent counterparty will obtain \$900 from the new license agreement she enters, but she will also suffer a loss of \$100. Since the estate will pay this claim in “Bankruptcy Dollars”, she will only receive \$4. This far, the arithmetic operation has been quite simple. If the bankruptcy estate will gain more from breaching the contract than the other party will receive as a result from the breach, a breach seems to be justified. The trustee will save the estate \$100 in performance (the sum exceeding the today value of the license), but only has to pay ratable damages amounting to \$4. The increase of the estate value resulting from breach fully corresponds to the loss suffered by the solvent counterparty (\$96). In this simplistic example, welfare is not affected since – in theory – the counterparty will lose what the creditors will gain.¹⁹⁷

¹⁹⁴ Terminology from Freid, *Executory Contracts and Performance Decisions in Bankruptcy*, p. 519.

¹⁹⁵ The following example is inspired by Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, p. 531 et. seq.

¹⁹⁶ Indeed, he will not be indifferent. By entering the contract he might take the risk of making the estate administratively liable for additional damages, due to e.g. defects in the estate’s performance. However interesting this matter may be, however, it will not be further dealt with here.

¹⁹⁷ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 108 (“simply a wealth transfer”).

The argument is equally valid regardless if the licensor instead of the licensee enters bankruptcy, the only difference being that the former will have struck a good deal when the latter has made a bad one (and vice versa). In sum, the trustee will only enter those contracts that have turned out to be good deals on the debtor's behalf, and reject all others. Furthermore, the trustee can profit from breach where the debtor could not.¹⁹⁸

The common argument supporting this order is based on the bankruptcy principle of creditor equality.¹⁹⁹ The trustee should enter into contracts if, and only if, they yield a net benefit for the creditors as a group (i.e. if they represent net assets). If one creditor were to be paid ahead of the others, it would be tantamount to giving that creditor priority, and accordingly the principle of creditor equality would be violated.

5.1.4 *Welfare Implications and the Problem of Excessive Rejection*

Still, transactions obviously cost.²⁰⁰ By way of example, the solvent counterparty of our example – in order to license her technology to someone else – must engage in marketing efforts. Further she must evaluate potential licensees and finally she must negotiate and draw up a new contract. To enliven our discussion, let us assume that she will incur costs amounting to a total of \$50, need she enter into a new license agreement (regardless the value of the technology). Once these costs are taken into account, our model will be somewhat complicated. The basic considerations, however, will be the same.

If the licensed technology is worth more to the estate than its corresponding obligations, the trustee will clearly have the same incentives as before. Put rather simple: If the debtor has made a good deal, the estate should take advantage of it. Even in the scenario where the contractual rights and obligations are a perfect match (the contract in balance), the trustee will not to breach the contract. This is so, because if he would, the solvent counterparty would be entitled to \$50 for her damages (the additional costs from establishing a new license agreement), and the value of the estate would be reduced with \$2 (it would have to pay 4 % of \$50 instead of paying nothing).

Now imagine that the license is again only worth \$900, while the estate's obligations amount to \$1000. And let us not forget that the solvent counterparty lives in the real – i.e. costly – world. The trustee's calculation will still be basically the same, but he must also take an additional claim for damages into account. By rejecting the contract, he will save the estate \$100 worth of performance. But at the same time the solvent counterparty will become entitled to damages, now amounting to a total of \$150. Since these are payable in "Bankruptcy Dollars", the amount received will in practice be only \$6 (4 % of \$150). From the trustee's perspective, the choice is easy: Better to pay \$6 than to perform \$100.

¹⁹⁸ Westbrook, *A Functional Analysis of Executory Contracts*, p. 266 et. seq.

¹⁹⁹ Baird et. al., *Cases, Problems and Materials on Bankruptcy*, p. 188; *Bankruptcy: The Next Twenty Years*, p. 462 et. seq.; Jackson, *The Logic and Limits of Bankruptcy Law*, p. 109; *Reforming the Bankruptcy Code*, pp. 120 et. seq. and 129; Westbrook, *A Functional Analysis of Executory Contracts*, pp. 252 and 255 et. seq.

²⁰⁰ The following inspired by Coase, *The Firm, the Market and the Law*, p. 114.

If the trustee were to breach, welfare would actually decrease. And it is easy to see why. While the estate gains \$94 from the breach, the solvent counterparty loses a total amount of \$144 (\$150 minus \$6). The net loss to society, that is the extra costs incurred by the solvent counterparty (\$50), would have been avoided had the trustee not breached the contract. Because the trustee's only concern is the amount that the suffering party actually receives, he does not care whether the contract is in fact value creating or not. Or put in economic terms: The total loss is not internalised in the assessment that the trustee makes prior to breaching the contract.²⁰¹ What is more, the trustee's incentive to reject value-creating contracts seems to increase when the payout rate goes down.²⁰² If the average rate had been 67 %, for example, the trustee would not have breached in our example. But with a rate as low as 4 %, he will not refrain from rejection until the license value amounts to \$998 (that is when the expected dividend to the counterparty exceeds the estate's initial benefit from breach).

5.1.5 *The Impact of Property Rights and Avoidance Powers*

The trustee's assessment of the value of a contract should be calculated according to the same rationale as regarding other assets.²⁰³ Contracts – just like other assets – may be burdened with the entitlements (or property rights) of others. The rationale for establishing such property rights (e.g. security interests) is not a bankruptcy matter.²⁰⁴ Their only relevancy in bankruptcy proceedings is that they should be recognised, to not reintroduce the common pool problem (alterations in the distributional order will inefficiently influence the creditors' ability to act as one). The enforcement of such property rights constitutes a major exception to the principle of creditor equality and the corollary rule of *pro rata* distribution.²⁰⁵

In Sweden, the conditions for acquiring property rights are manifold, and usually depend on the kind of transaction involved. For example, if a buyer of tangible goods pays a seller in advance, the seller must be effectively dispossessed for title to pass. Otherwise the buyer will not have a specific right to the goods in the face of the seller's other creditors. Rather, the goods will be realised by the trustee, in the interest of all creditors, and the buyer's claim will be converted to an unsecured monetary claim for damages.²⁰⁶ If the sales transaction had instead involved the sale of an industrial property right, such as a patent, the non-debtor party's entitlements will be subject to other considerations. First, if the debtor has sold such property, title will pass to the non-debtor party through contract (intangibles can not sensibly be possessed, and as a corollary the debtor can not be dispossessed).²⁰⁷

If the acquired entitlement were merely the right to use a patent (i.e. a licence, or usufruct), the traditional view would say that the licence should not be respected in the licensor's bankruptcy. But this view has been overthrown by legislative measures

²⁰¹ Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, p. 531.

²⁰² Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, p. 533.

²⁰³ Jackson, *Translating Assets and Liabilities to the bankruptcy Forum*, p. 70.

²⁰⁴ Westbrook, *A Functional Analysis of Executory Contracts*, p. 258.

²⁰⁵ Westbrook, *A Functional Analysis of Executory Contracts*, p. 260.

²⁰⁶ For a discussion on the Swedish attitude towards ostensible ownership (an illuminating example of the "false wealth" doctrine), see generally Hästad, *Sakrätt avseende lös egendom*, p. 216 et. seq. and Wood, *Principles of International Insolvency*, p. 35 et. seq.

²⁰⁷ Hästad, *Sakrätt avseende lös egendom*, p. 264 et. seq.; Möller, *Konkurs och Kontrakt*, p. 743 et. seq.; SOU 1985:10, p. 43 et. seq.

and, as of now, the licensee’s right to use a patent or trademark will also hold in relation to the licensor’s other creditors (PatL, §§ 101-103; VML, §§ 34 h-j).²⁰⁸

Furthermore, by way of official registration, patents and trademarks can be used as security (PatL, §§ 94-104; VML, §§ 34 a-j). When a creditor obtains such security, she will become a “separatist” in bankruptcy. Her security will be of a “proprietary” character – just like a conventional possessory pledge – and as a rule she will be unaffected by bankruptcy.

This far we have discussed what may be called property rights in a somewhat narrow sense. But from a functional perspective even security interests of a mere priority character should be treated as such. Any presumptive creditor may obtain different kinds of security in the debtor’s assets. Leaving tangibles and real estate aside, she may e.g. obtain a relative security interest in the debtor’s assets, a so-called floating charge.²⁰⁹

If we were to return to our fictitious license agreement and grant our solvent counterparty a non-avoidable security interest, we will see that she will actually opt out of the RD rule, totally or partially. Assume for example that she were given a floating charge in the debtor’s assets, amounting to a nominal value of \$1100 (and that at the time of reckoning there are actually assets to that same amount or more). If the trustee were to breach the contract, the function of her security would be that she is awarded expectation damages instead of only a fraction of her initial entitlement. In the case where the value of the license has decreased to \$900, she would thus be entitled to the full \$150 in damages (after having licensed the technology to someone else). Had she obtained security to a lesser amount (say \$1000), her claim for damages would be partially satisfied on a *pro rata* basis ($\$100 + \$50 \cdot 4 \% = \$102$). A security interest will thus compel the estate to internalise more or less of the costs arising from its breach, as it will thus have a corollary and greater incentive not to breach value-creating contracts.²¹⁰

If the conditions of our example were to be altered so that instead the licensor was the one involved in bankruptcy proceedings, the (solvent) licensee need not obtain any security. At least not to protect the licence as such, since in Sweden it is now a legitimate property right. She might however be interested in protecting her other entitlements according to the contract by obtaining a legitimate security interest (e.g. in the patent). Without engaging in yet another arithmetic operation, it is easy to see that this situation is a functional equivalent to the original example, notwithstanding the differences in detail.

Previously it has been shown that bankruptcy calls for some retroactivity. Strategic planning in the pre-bankruptcy period must be obstructed, if the collectivisation goal is not to be jeopardised.²¹¹ Thus, property rights that are *prima facie* legitimate may sometimes be reversed and as a consequence will not be respected in bankruptcy. In Sweden, for example, bankruptcy proceedings will capture some security interests

²⁰⁸ As interpreted by Hästad, *Sakrätt avseende lös egendom*, p. 434 and Möller, *Immaterialrätt och konkurs*, p. 28 et. seq.

²⁰⁹ Here the Swedish law provides for a registration procedure, not unlike the one for security in real estate. See generally Hästad, *Sakrätt avseende lös egendom*, p. 353 et. seq.

²¹⁰ Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, p. 537 et. seq.

²¹¹ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 124.

that have been established in a pre-petition period of three months. If they are established at the same time that debt is incurred, however, they will ordinarily not be affected.²¹² These circumstances are as valid in connection with dealing with contractual rights and obligations as they are when dealing with “ordinary” assets and liabilities.²¹³

5.1.6 The Evaluation of Mutually Unperformed Contracts in a Nutshell

The trustee will face a complicated assessment. Most contracts involve multiple rights and obligations (or assets and liabilities). Because of the contractual interdependence between these rights and obligations, a potential surplus is only accessible to the estate if it will actually perform on the debtor’s behalf.

The trustee’s evaluation of a mutually unperformed contract will proceed in different steps.²¹⁴ First he must ask himself whether or not the contract comprises a legitimate property right (such as a security) and if so, if it is avoidable. And secondly, he must ask himself if the estate will profit more from performance or from breach, knowing that a claim for damages following a breach of other covenants than those covered by legitimate and non-avoidable property rights will be payable only in “Bankruptcy Dollars”.

If, and only if, property interests can be avoided according to explicit rules, will the initially secured interests of the solvent counterparty be included in the calculation as “bankruptcy” liabilities, thus being evaluated on the basis of the RD rule. Indeed, it is material to observe that avoidable interests of solvent parties do not actually disappear. Instead they amount to general claims, in practice entitled to a mere dividend in the distribution of proceeds.

5.2 The Economics of Ipsa Facto Clauses

Now let us turn to a situation where the solvent counterparty to a contract will want to terminate the contract upon the debtor’s bankruptcy. To ensure such a right, ipso facto clauses are frequently inserted into license agreements. Such a clause might read as follows.

“Without prejudice to any remedy either party may have against the other party for breach or non-performance of this agreement, either party shall have the right to terminate this agreement with immediate effect upon written notice to the other party, in the event of insolvency of the other party or the institution of any liquidation, bankruptcy, dissolution, composition with creditors, receivership, trustee or similar proceedings in respect of the other party.”²¹⁵

²¹² KL, Ch. 4 § 12.

²¹³ Westbrook, *A Functional Analysis of Executory Contracts*, p. 259.

²¹⁴ As eloquently structured by Westbrook, *A Functional Analysis of Executory Contracts*, p. 336.

²¹⁵ I am indebted to Jan Kansmark and Zoran Stambolovski at Mannheimer Swartling Law Firm in Malmö for providing me with, and permitting me to use, some examples of ipso facto clauses.

At first we have to acknowledge the fact that the clause merely provides a right to opt out, not an automatic “trigger”. Clearly the solvent counterparty may or may not have an interest in terminating, depending on the circumstances. In our previous discussion it is understood that she will not have such an interest when continued performance will maximise wealth. Instead, the problem is quite the opposite, since the estate – due to the RD rule – might have a contrary incentive to breach. Occasionally, however, the solvent counterparty does have an interest in terminating the contract. More specifically this is so when the insolvent party has made a good deal and the trustee wants to take advantage of it. By bringing the contract to an end, while at the same time ruling out any liability for damages, the solvent counterparty could instead enjoy the increase in value (in our example by licensing the technology to someone else).

To fully comprehend the importance of ipso facto clauses, our fictitious license agreement will be put to use again. In the present context, we will obviously only consider the situation in which the value of the licensed technology has actually increased since the contract was agreed upon, thus leaving the solvent licensor with an incentive to terminate.

5.2.1 Ipsa Facto Clauses and Estate Maximisation

Consider again the situation where the licensed technology is worth \$1100 to the bankruptcy estate, while the value of its performance merely amounts to \$1000. The trustee will not have an incentive to breach. Rather, he will require performance since it increases the total value of the estate. If the solvent counterparty could rely on an ipso facto clause, such as the one cited above, she could however exclude this right of the estate and enjoy the fruits of prosperity herself.

But would this not run contrary to the principle of collectivisation (i.e. the principle of maximising the value of the estate)? Indeed, many scholars argue that it does. According to the dominating Swedish view, for example, contracts which have the sole intention of worsening the position of the debtor’s other creditors should be regarded as null and void.²¹⁶ An ipso facto clause is argued not to impose any cost on the contracting parties, while at the same time imposing one on the debtor’s other creditors. The fact that the debtor may even obtain certain benefits (e.g. lower interest rates) allegedly provides further support for this view, since it thus seems that she also will have an incentive – quite opposite to the interests of her creditors – to offer such clauses.²¹⁷ Several leading scholars in the United States argue from a similar standpoint, some of them even with economic preferences.²¹⁸

At a first glance, the argument seems to hold. If the solvent licensor is allowed to exit (through an ipso facto clause), she will not merely receive the estate’s performance

²¹⁶ Hästad, *Sakrätt avseende lös egendom*, p. 404; Lindskog, *Kvittning Om avräkning av privaträttsliga fordringar*, p. 172; Möller, *Konkurs och kontrakt*, p. 71 et. seq.

²¹⁷ Hästad, *Sakrätt avseende lös egendom*, p. 403 et. seq.; Möller, *Konkursboets inträde i gäldenärens avtal*, p. 181.

²¹⁸ See e.g. Jackson, *The Logic and Limits of Bankruptcy Law*, pp. 41 et. seq. and 103 et. seq. It should be noted that Jackson seems not to be entirely convinced (the other creditors are “likely to bear the cost” and the refusal to recognise ipso facto clauses “may be destructive of the collective weal” (emphasis added)).

worth \$1000. Rather she will be able to license her technology to someone else for \$1100, making a “profit” of \$50 (net her costs for marketing etc.). Assuredly, she will want to exit. The estate, on the other hand, will decrease in value by an amount of \$100 (it will lose \$1100 worth of technology, while at the same time escaping performance amounting to \$1000). This situation seems to be quite contrary to the goal of estate maximisation. What is more, it will lead to resources being put to their second best use, i.e. generating \$50 instead of \$100. Welfare will decrease rather than increase. Or at least this is the immediate impression.

5.2.2 *The Coase Theorem and Bargaining Ex Post*

In a world without transaction costs, rights (or factors of production) will be constantly rearranged as long as the value of production is increased. Finally, they will end up with the owners that value them the most. And this regardless of whom has the initial entitlement.²¹⁹ Or, as Coase himself has put it,

“/.../ the law merely determines the person with whom it is necessary to make a contract /.../”²²⁰

This simple version of the Coase theorem seems to hold in a bankruptcy context. There are merely two parties involved in negotiations, the trustee and the solvent counterparty, both of whom are likely to be adequately informed. Thus the rights of the contract will end up with the party that values them the most. This understanding will indeed play down the significance of the aforesaid apprehensions, a fact that will now be proved by way of example.²²¹

We have seen above that the solvent licensor will have an incentive to exit costlessly from a contract, where possible, when the today value of her performance has increased. Instead of receiving the agreed \$1000, she could instead license her technology to someone else and receive an additional \$50 net surplus. One may question whether she will actually use the right to exit provided by a contractual clause, given that the estate would lose \$100 if the contract were to be terminated. The answer ought to be no. Because the estate will benefit more from continuance than the solvent counterparty will profit from terminating, the trustee would probably be interested in paying her an amount between \$50 and \$100, were she to perform. If the *ipso facto* clause were to be nullified, however, no such bargain would be necessary. Either way, the efficient outcome would be that the contractual relationship was upheld, and that outcome would also take place.

On the other hand, if the solvent licensor’s gain from exit were to exceed the estate’s benefit from continuance, the former would instead bribe the latter. That is, if she does not have the contractual right to exit. For example, the today value of the licensed technology could be larger to an outside party than to the estate. Imagine that an outside party has offered an amount of \$1200 for the said license. Leaving transaction costs aside and given that *ipso facto* clauses were illegal, the licensor would be

²¹⁹ Coase, *The Firm, the Market and the Law*, pp. 114 and 158; Polinsky, *An Introduction to Law and Economics*, p. 12.

²²⁰ Coase, *The Firm, the Market and the Law*, p. 157.

²²¹ The following discussion inspired by Che et. al., *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, p. 443 and Schwartz, *A Contract Theory Approach to Business Bankruptcy*, p. 1842 et. seq.

induced to pay the estate an amount between \$100 (the estate's benefit from continuance) and \$200 (the licensors benefit from exit). Again the efficient outcome would prevail.

In the latter example, as in the preceding one, we see that the function of an ipso facto clause merely amounts to assigning the initial “property” right. Regardless who has that property right – the licensor through an ipso facto clause or the estate through a ban on such clauses – the optimal outcome will obtain. The difference between the two situations amounts to nothing more than a distribution of income.²²²

To picture the distributional effects, let us return to the first example, in which the estate would benefit \$100 from continuance, whereas the solvent counterparty might benefit \$50 from opting out. Let us call the difference between the two situations “rent”,²²³ and further assume that both parties possess the same bargaining powers (i.e. can bargain for 50 % of the said rent). If ipso facto clauses are sustained, the trustee would thus pay \$75 for the licensor not to exit, and conversely, if the clause is banned, he would not have to. If such clauses are recognised, income will be distributed to the benefit of the solvent counterparty and vice versa. Let us now turn to consider the second case. If the estate would benefit \$100 from continuance, but the solvent licensor would benefit \$200 from exit, the latter would instead bribe the trustee for permission to exit (with an amount of \$150), while an ipso facto clause would entirely exclude the need for such a payment. In the first scenario, where the optimal value of production amounts to \$100, that income would be distributed \$25/\$75 instead of \$100/\$0, were an ipso facto clause to prevail. And in the second, where the optimal outcome would generate \$200, this amount would be split \$0/\$200 instead of \$150/\$50. It is clear that ipso facto clauses, if legal, distribute income to the benefit of the solvent party.

5.2.3 *Income Distribution and Voluntary Creditors*

Some would still argue that the initial problem remains. The primary purpose of bankruptcy law, as we have understood it, is to solve the creditors' co-ordination problem and thus maximise the value of the estate. If ipso facto clauses are to be legalised the distributional effects will burden the debtor's other creditors, and the collective weal might thus be undermined.²²⁴ This far, an ipso facto clause seems merely to be an illegitimate try to opt out of the collectivisation principle, in that it is to the detriment of the creditors as a group. But we miss one important point.

Unlike the debtor's managers (acting in lieu of the shareholders), who are primarily interested in the “upside potential” of the firm's projects, voluntary creditors' main focus is the “downside risk”.²²⁵ When the firm prospers, creditors are paid, as are the

²²² Mercurio et. al., *Economics and the Law. From Posner to Post-Modernism*, p. 68; Polinsky, *An Introduction to Law and Economics*, p. 12.

²²³ The “rent” being the difference between the value of production in two given situations, one of which is the better, or optimal, one. Coase, *The Firm, the Market and the Law*, p. 163 et. seq.

²²⁴ Jackson, *The Logic and Limits of Bankruptcy Law*, p. 42.

²²⁵ Bergström et. al., *Aktiebolagets grundproblem*, p. 163.

shareholders, and there is no conflict of interest.²²⁶ But when bankruptcy is imminent, creditors face the risk of losing money while at the same time the shareholders (through the managers) have little incentives to engage in potentially value-creating projects.²²⁷ The creditors are aware of this so-called “underinvestment” problem. And as a consequence, they will charge a risk premium for extending credit, the rate of which will differ depending on their chances to recover payment when the debtor becomes insolvent. Thus, there are no externalities in relation to voluntary creditors. They are compensated *ex ante* for the risk that they face *ex post*.²²⁸ And as the other creditors are not done wrong in any way, the alleged negative effects of ipso facto clauses are consequently outweighed.

5.2.4 *Ipsa Facto Clauses and Efficient Incentives to Invest*

So far it seems that the presence of ipso facto clauses leaves welfare unaffected. If we are not to jump to conclusions, we must however ask ourselves if such clauses increase welfare in any other way. And by linking our discussion more intimately to corporate law, we will see that they actually do.

If ipso facto clauses are not sustained, we have seen that the trustee (acting in lieu of the creditors) can capture renegotiation rents. To a creditor, this amounts to an obvious risk of losing money when the firm goes down, a risk that will be compensated for in the sum (price, interest rate or the like) that the debtor is required to pay when solvent. Since the debtor will be obliged to pay more for debt, she will not be able to fund as many good projects as she could have done when able to offer contracts containing ipso facto clauses. Neither will she have as good incentives to invest in these projects.

If the debtor were to give up her ability to obtain rents in bankruptcy – as she can do by offering an ipso facto clause – she could actually keep more of the upside and thus would have better investment incentives. Such a clause, if legal, would represent a significant commitment in relation to the creditor in question.²²⁹ And because the creditor’s downside risk is minimised, the debtor will obtain a better deal (e.g. a lower interest rate). Not being required to share as much of the upside with her creditors, the negative effects of underinvestment would be limited.²³⁰

To fully understand the effect of ipso facto clauses, we will again return to the previous two examples. In the first situation the solvent counterparty would either give up her right to renegotiation rents or capture some of it (\$0 or \$75), the latter if an ipso facto clause were to prevail. In the second example the amounts would be \$50 or \$200. The presence of an ipso facto clause would act as a guarantee of a lesser loss. If such clauses were to be outlawed, the creditor would accordingly be inclined to charge compensation for the expected loss by requiring the solvent debtor to per-

²²⁶ Except for the so-called ‘over-investment’ problem. The firm’s inclination to engage in risky activity increases corollary to the ratio of debt financing. Bergström et. al., *Aktiebolagets grundproblem*, p. 161.

²²⁷ Bergström et. al., *Aktiebolagets grundproblem*, p. 162.

²²⁸ Bergström et. al., *Aktiebolagets grundproblem*, p. 187; Che et. al., *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, p. 447; Easterbrook et. al., *The Economic Structure of Corporate Law*, p. 50 et. seq.

²²⁹ Che et. al., *Section 365, Mandatory Bankruptcy Rules and Inefficient Performance*, p. 448.

²³⁰ Che et. al., *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, p. 461; Schwartz, *A Contract Theory Approach to Business Bankruptcy*, p. 1846.

form at a higher rate (in our case a higher rate of monetary performance). The risk premium would balance the total result so that the estate would not actually profit at all. In the first example, the estate's performance would amount to \$1075 instead of \$1000. And in the second, it would be required to perform a total of \$1150. In both cases, the license clearly would not have been agreed upon in the first place, a fact that highlights the underinvestment problem as well. If cost for debt is high, available funds will be less and fewer projects will be pursued (some not at all).²³¹ This is a crucial point indeed: If investment opportunities decrease, as well as the shareholder's incentives to invest, some projects will not be pursued at all and those that are may fail. This reduction in social wealth will also be a risk that creditors must face, and consequently they will charge an additional risk premium (besides the \$75 and \$150).

If we were to accept the argument that *ipso facto* clauses reduce welfare by undermining efficient collectivisation, and thus ought to be banned, we have seen that worsened terms of trade for solvent firms will actually lead to total inefficiencies instead.²³² The estate's *ex post* value will not increase through a ban, rather it will decrease due to the described *ex ante* effects. Note that the creditors not only will compensate themselves for the immediate effect of a ban (i.e. the estate's benefit from obtaining renegotiation rents), but will also ensure *ex ante* remuneration for the decrease in value following from the perverse incentives to invest.

5.2.5 *The Problem of Excessive Rejection Revisited*

Previously, when discussing the RD rule, a problem seemed to surface. Because the trustee is liable to pay damages in tiny "Bankruptcy Dollars", he will have incentives to breach the debtor's contracts when they are unprofitable to the estate, regardless whether performance would be socially desirable or not.

Recall the situation where the licensed technology's today value is \$900 and the estate is obliged to perform \$1000. The trustee would have a clear incentive to breach, regardless if it were socially inefficient or not. Following such a breach, the solvent counterparty could enter into a new license agreement, thus facing a total loss of \$150 (including costs amounting to \$50). After being awarded ratable damages in "Bankruptcy Dollars", the solvent licensor would have lost \$144 and the estate only \$6. Total loss would amount to \$150, compared to the \$100 total loss that would follow from continuance. Welfare would decrease with \$50, were the trustee to breach the contract.

Solutions to the alleged problem of excessive rejection have been proposed. But they admittedly encounter technical difficulties or efficiency drawbacks.²³³ However, given that the assumptions of low transaction and information costs hold in this scenario, the problem of excessive rejection is probably exaggerated.

The trustee would probably not breach if the estate were made better off in some way. And because the value of production would be greater if the contract remained in force, he could probably be induced not to. Assuming again that both parties pos-

²³¹ Che et. al., *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, p. 448.

²³² Schwartz, *A Contract Theory Approach to Business Bankruptcy*, p. 1843.

²³³ Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, p. 539 et. seq.

– *Ipsa Facto Clauses* –

With equal bargaining powers, the solvent party would most likely bribe the trustee with an amount of \$119. As that amount clearly is more than \$94, the trustee would not breach. The bargain would leave the estate with \$25 more (50 % of the rent) than it would have gained from breaching the contract. And as the solvent party faces a loss of only \$119, instead of \$144, she too would be left \$25 better off. Bargaining *ex post* thus will eliminate the feared efficiency drawbacks of excessive rejection.

6. Summary and Conclusive Remarks

After a trip from the general to the special (or from the easy to the difficult), things need to be brought together. Just like it is appropriate to provide the reader with a transparent and unambiguous point of departure, an academic thesis – the present being no exception – must offer some kind of closing statement. Here it is.

6.1 *Ipso Facto Clauses Should Prevail*

With civilisation came credit. And with credit came debtor default. History proves that multiple creditors are not likely to get together when the debtor's assets do not suffice in satisfying all. Instead every creditor would probably engage in a destructive race for assets, trying to get satisfaction in the face of the others. A collective proceeding is of need, bringing the creditors together as one and thus facilitating orderly and efficient liquidation. Such a collective regime must be binding for everyone, hence the need for mandatory bankruptcy rules.

This principle of collectivisation is recognised by all. Unfortunately, however, it is frequently taken as a pretext for holding that all bankruptcy-related rules are of a mandatory character. The estate as such (or rather its value) faces the risk of being torn apart by creditor actions. That is, if it is not safeguarded by law.

Quite contrary to the aforesaid, creditors everywhere are given the right to secure their claims in various ways, all in the interest of commerce and credit. In such a context, one must question why ipso facto clauses are so unfairly treated.

By plunging deeper into behavioural patterns, insolvency matters can be better understood. Law and Economics provide excellent guidance for how bankruptcy analysis should be carried out. Instead of addressing all problems entirely from an *ex post* perspective – or from “within” the bankruptcy estate, if you like – the discourse must take into account all the various actors involved in bankruptcy and all the implications on their behaviour that bankruptcy may pose. Only by engaging in such an inquiry, can one properly understand that ipso facto clauses pose no problem.

6.1.1 *The Limits of Orderly Debt Collection*

Yes. There is an initial conflict. Without a mandatory collective regime, the creditors will act in their respective self-interest only. Because they can not get together, they will be inclined to race for assets trying to get paid ahead. Such strategies would not occur, were the creditors to act as a sole owner would. By providing a mandatory collective regime, bankruptcy law eliminates strategic behaviour as well as administrative inefficiencies, while at the same time preserving going concern values (if any).

This regime should not be concerned with distributional matters (however politically correct it may be to pity some groups when companies fail). Property rights should be established by non-bankruptcy law, and merely vindicated in the collective debt-collection procedure. If bankruptcy law were to create new entitlements, the collec-

tive action problem would surface anew. By providing some – and not all – with special “bankruptcy privileges”, perverse incentives are created and thus bankruptcy may be used to satisfy some self-interested parties instead of being beneficial to all. This is crucial indeed: Bankruptcy may only create entitlements in order to vindicate its core function, which is that of an orderly and efficient debt collection device. No more, no less.

6.1.2 A Functional Approach to Property and Contracts

A concept other than a functional one is of little use when addressing property issues. Any given property may be of value to someone, but also it may not. If the value of someone’s property rights exceed the value of (better) rights held by others, it will represent an asset. And conversely it may be regarded as a liability, if the values were to be transposed. A mutually unperformed contract involves a multitude of rights and obligations. These are necessarily intertwined, as well as they are interdependent. One contracting party can not deny the other her rights, without paying damages for breaching the contract.

In bankruptcy, the contract setting is functionally and essentially different from its non-bankruptcy equivalent. Due to the debtor’s financial predicament, no creditor can expect but a small portion of her unsecured claim for damages. Put in other words, the solvent party to a contract will be paid in tiny “Bankruptcy Dollars”, if the trustee chooses to breach. By properly understanding the context in which the trustee makes his assessments, it is clear that breach will occur more frequently than solvent counterparties wish. They can however bribe the estate to continue, and thus make the problem of excessive rejection disappear. Excessive rejection can be eliminated by security as well, in which case even other benefits to the solvent party will appear. By safeguarding her rights according to the contract with some kind of security, the solvent counterparty will opt out of the “ratable damages” rule, and as a consequence the trustee will have to take account of (or internalise) the total loss that may follow from his breach. Security thus comes with the desirable effect (for the solvent party, that is) that the estate is prevented from capturing the renegotiation rents that it would otherwise – through the RD rule – have had access to. In this setting *ipso facto* clauses fill no function.

6.1.3 Ipsa Facto Clauses Improve Social Welfare

An *ipso facto* clause does however serve its purpose, given that a termination of the contract is beneficial to the solvent counterparty. By vesting the initial property right in the solvent party, exit on her behalf is made costless and again the estate is excluded from obtaining renegotiation rents. Instead, the trustee will bribe the solvent party to continue, were the estate to benefit more from continuance than the she would gain from terminating the contract. This is all *ipso facto* clauses do. They assign the initial property right.

What is more, by assigning that right to the solvent counterparty, an *ipso facto* clause reduces the downside risk that she will face when the debtor goes down. Thus, she will charge a lower rate of performance from the debtor (when solvent), and thus the debtor will have better opportunities to fund her projects. Because she does not have

to share as much of the upside return with her creditors, the debtor will furthermore have better investment incentives. With more projects effected and greater overall chances of success, the debtor will hopefully and more likely avoid bankruptcy. If she does not, the estate will at least be maximised, and thus the ultimate goal of bankruptcy can be accomplished. The creditors are sure to consent, were they able to get together as one.

6.2 Final Comments on the Swedish Position

The Swedish attitude towards ipso facto clauses is by no means uniform. Law has furnished the estate with disparate rights to enter the debtor's outstanding contracts, of which none are explicitly mandatory. Further it seems that some twenty years of scholarly debate have accomplished little or nothing.

The dominating view holds that ipso facto clauses obstruct estate maximisation. By awarding one creditor special treatment while at the same time maltreating the others, such a clause runs contrary to the first principles of bankruptcy law. Or so the argument goes. Occasionally, however, contrary views surface. Being the Cinderellas of Swedish bankruptcy debate, these opponents sometimes argue from an implicitly economic perspective.

This thesis has proved the view of the opponents to be the better one. The scholarly hostility towards ipso facto clauses is based on a narrow (i.e. defective) perspective, not taking into account all that matters. By widening the paradigm to comprising even corporate and security-related aspects, while at the same time actually trying to predict – rather than guess – how different economic agents act and react, it is clear that ipso facto clauses are socially desirable.

In Sweden, because the legal position is inadequate and because the dominating scholars have argued for so long that the creditor-estate conflict calls for the nullification of ipso facto clauses, no investor will know what to expect. Nor will the legal practitioner acting as a bankruptcy trustee have much aid in the negotiations that must inevitably take place.

6.3 A Modest Proposal for Legal Reform

I must side with the majority of scholars and stress the importance of legal clarification. Unlike most of them, however, I will obviously argue that the estate should not be furnished with a mandatory right to enter the debtor's contractual relationships. Instead ipso facto clauses – as they have proved to be socially desirable – should be legally recognised.

Because renegotiations will usually take place, one can not expect the courts to provide such certainty. Rather, legislation seems to be the appropriate way to go. And while at it, why not aim at creating legal uniformity as well? By law, the estate has disparate rights of entry, but not with regards to several important kinds of contract (the licence agreement being one). By creating a uniform basis for all contracts, certainty could be generally accomplished. Such a rule should stipulate that the bankruptcy estate has the right to enter the debtor's contractual relationships as they

stand, provided that it either performs in full or provided that the solvent counterparty is adequately assured of the estate's future performance. More importantly, this rule should be made optional (i.e. possible to contract about).

By letting the solvent counterparty capture renegotiation rents, the ultimate goal of collectivisation (i.e. estate maximisation) will be accomplished, not counteracted. By providing the debtor (when solvent) with greater access to business funding, as well as with better incentives to invest, the *ex post* value of the estate will actually increase. Being the very foundation of contemporary bankruptcy theory, the argument of estate maximisation will thus refute – not vindicate – the argument that ipso facto clauses run contrary to creditor interests.

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²³⁴ The official third edition will be published in June 2000. I am indebted to Douglas G. Baird for providing me with tentative excerpts from this coming publication.

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