

Bankruptcy's Trilemma: A Unifying Framework

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ABSTRACT

We propose a unified framework to explain the key problems underlying corporate bankruptcy law. Creditor rights take two primary forms: the right to take assets from the debtor, and the right to block asset transfers from the debtor to third parties. Taking and blocking rights control *agency problems*, such as value-diverting transfers by management. But in financial distress, one creditor's rights can impose costs on the other creditors. Multiple taking rights creates the well-known *commons problem*: creditors can race to the debtor to collect, causing a valuable firm to liquidate. Bankruptcy law can stay the creditor race, but this creates one of two alternative problems. If creditor taking rights are replaced with blocking rights, this creates an *anticommons problem* of holdout and costly delay. Holdout problems can be mitigated by removing blocking rights for some creditors. But creditors who can neither take nor block are vulnerable to the same agency problems their contracts tried to prevent. These three problems--commons, anticommons, and agency--create bankruptcy's *trilemma*: when the law reduces one of the three problems, it tends to amplify one of the other two. Most of bankruptcy law's features are targeted at one of the three problems, and U.S. law's back-and-forth evolution over time reveals the inevitable tension between these forces.

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