BANKRUPTCY AND MASS TORT

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An enterprise markets a product that afflicts industrial workers with disease. A pharmaceutical manufacturer sells a drug that causes serious disorders in users and deformities in their children. Liability in tort is clear, we suppose.

Yet the effect of the industrial product or drug may be so pernicious, as it has been for those exposed to asbestos or DES, that the tort system produces—or may in the near future produce—an aggregate liability that may well exceed the value of the responsible firm.¹ The tort system normally creates simple financial liability to an individual or class after a single trial or settlement. But under circumstances of massive enterprise liability after multiple trials and settlements, that financial clarity and simplicity is quickly obliterated. Questions arise that the tort system does not explicitly answer. For example, should a large, immediate cash payout be allowed if it would destroy the responsible firm and leave later plaintiffs uncompensated?²

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¹ The asbestos and diethylstilbestrol (DES) disasters, moreover, may be more than isolated, sui generis problems; they may be but the first in a wave of mass torts, and, if no other institutional solution appears, of tort-based bankruptcies. One medical authority has concluded that the “[a]vailable data indicate that about 80 percent of cancer diagnosed in our society is occupationally induced by the inhalation of carcinogens produced in industrial processes.” Occupational Diseases and Their Compensation, 1979: Hearings on H.R. 2740 Before the Subcomm. on Labor Standards of the House Comm. on Education and Labor, 96 Cong., 1st Sess. 90, 96 (1979) (statement of Dr. Leon Cander, Chief of Internal Medicine, Albert Einstein Medical Center). As standards of strict enterprise liability become more prevalent or as changing fault-based standards become easier for plaintiffs to meet, the possibility of enterprises facing uncertain tort claims that may dwarf enterprise value increases. See also 40 Cong. Q. 2730 (1982) (Dr. Irving Selikoff, chief of the Environmental Science Laboratory of Mount Sinai Medical Center and an authority on asbestos-related diseases, attributed 10,000 deaths a year to asbestos exposure).

² I have little to say in this Article about the wisdom of the tort system’s results. If they are unsound, bankruptcy policy could exacerbate the error.

3. See Shavell, An Analysis of Causation and the Scope of Liability in the Law of Torts, 9 J. Legal Stud. 482, 499 (1980) (“If accident losses are unusually high and a risk-averse and incompletely insured injurer is found negligent, it might be desirable to have him pay only partial
Add to this financial problem of massive liability the epidemiological uncertainty inherent in the delayed latent effects of mass exposure to, say, a carcinogen,3—and the legal system faces the as yet unresolved problem of managing vague but possibly enormous future liabilities: individual identification of future tort claimants is ordinarily impossible. The size of the aggregate claims is difficult to predict with assurance. The seemingly simple result of tort liability after an isolated trial or settlement negotiation is eclipsed by the bankruptcy and financial considerations of managing massive but uncertain liability of a firm of finite value. The haphazard timing and scope of liability as tort trials proceed could be displaced by bankruptcy's planned early reorganization and redistribution of value.

These are not just abstract problems. One quarter of a million people may die of asbestos-induced maladies in the next several decades.4 Already three asbestos manufacturers have filed petitions in bankruptcy, involving billions of dollars in assets and affecting tens of thousands of current and potential tort claimants.5 In two of the proceedings the district courts have held that no reorganization could take place that affected contingent future tort claims.6 The first court—whose analysis was approved by the second—seems to have been intimidated by the complexity arising from the uncertainty surrounding those claims. It feared on the one hand that an early reorganiza-

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3. Diseases such as asbestosis or mesothelioma, which are asbestos-induced, may not develop until decades after the asbestos fibers lodge in the victim's lungs or elsewhere in the body. Similarly, the ill effects of a drug such as DES, which has been used to prevent miscarriages, may only appear years after its use when it induces cancer in the users' children.


tion might be misused by a firm to escape its tort liability. Yet it feared on the other hand that a failure to reorganize early could cripple the firm and leave later tort victims with empty claims against a corporate charter. The court seems to have been unable to find a practical basis to resolve these tensions in a manner consistent with the Bankruptcy Code. In the third proceeding the bankruptcy court has yet to face the pivotal issues of statutory construction, but has suggested that it would search for alternatives to the results reached by the two district courts. In short, the courts have not yet found a satisfactory approach to the bankruptcy problem of a mass tort disaster.

Four crucial bankruptcy and finance questions arise from these tort-based bankruptcies: First, can a general approach be derived from bankruptcy's basic principles to address the financial problems that arise when tort liability threatens to overwhelm the firm? In particular, should there be an early reorganization of the firm's financial structure that includes the contingent tort claims of those whose injuries have yet to manifest themselves?

Second, as a practical matter can an early tort-based reorganization effectively implement these basic bankruptcy principles? How can one compensate as yet unidentified victims? How can one value these uncertain future claims against a firm itself of uncertain future value? Third, even if the problems of practicality are surmounted, can they be overcome consistently with the Bankruptcy Code and the notice requirements of constitutional due process? Fourth, if a practical basis for early reorganization under the Code could be found, who would be hurt thereby and how could they react? Could those in a position to defeat a decision to reorganize defeat a tort-based reorganization? If a change in the Code is needed to resolve this issue, what form should that change take?

I shall argue in Part I that basic bankruptcy principles suggest that when future claims are large in relation to firm value there should be an early reorganization that resolves those claims. To refrain from an early reorganization could seriously and deleteriously affect the firm's operations, lowering the firm's value and thus impairing the value of future claims. Yet practical problems of management, uncertainties of claim valuation and the impossibility of identifying future claimants seem to pose significant obstacles to the


8. 29 Bankr. at 744, 746.


10. Since the phrase "contingent future claimants" seems cumbersome, I will refer to these individuals as "contingent" or "future" claimants. But the reader should not misconstrue this shorthand usage. These claimants are those whose "contingent" or "future" claims arise solely from past acts of the bankrupt firm, acts that occurred prior to bankruptcy. They do not include those individuals who would become claimants due to future acts, acts that at the time of bankruptcy have yet to take place.
effective implementation of these principles in a reorganization in which future as well as present claimants are fairly compensated.

I shall suggest in Part II, however, that an approach that utilizes an analogy to commonly used financial instruments—the bond indenture, the pension fund and the variable annuity—provides a practical foundation for implementation of a claims pool that would reduce much of the potential for erroneous distributions due to the valuation and identification uncertainties.

When contingent tort claims have a probabilistic value far in excess of the value of a firm with an all-common stock structure, the reorganization institutions could substantially eliminate the old common stockholders and issue new common stock to a trustee, thereby turning over the firm's value to the tort claimants. The trustee would in turn sell the stock into the market, diversify the pool from which the contingent claimants will be paid, and pay those claims on a pro rata basis as they come due. Other uncertainties that could cause an immediate reorganization to produce mistakes in distribution are often unlikely to be resolved by delay. The tort claims' ultimate aggregate value often is likely to remain uncertain for years, perhaps decades. Some of these uncertainties and chances of mistaken distributions are quite similar to uncertainties present in most business bankruptcies, due to inherent inaccuracies in currently valuing the uncertain future.

In Part III I turn to the Bankruptcy Code. The first court to squarely face these issues interpreted the Code to bar an early reorganization with a pooling of uncertain future claims. This construction of the Code is unconvincing, however.

In Part IV I examine the most difficult issue raised by immediate reorganization and a pooling of future claims. While resolution of an ongoing reorganization is practical and arguably consistent with the statute, the conflicting interests of shareholders, management, contract creditors, current tort creditors and future tort creditors may make it difficult to initiate a reorganization. That is, those who might be adversely affected by claims pooling could—to the extent that they can influence corporate decisions—frustrate pooling in future cases by preventing, or at least delaying, reorganization. Thus, statutory reform will be necessary in order to control such reactions in future cases. The conflicts are sufficiently deep that no perfect solution is available; one can only compromise competing considerations.


12. I will not address several other questions that deserve further inquiry, but are beyond the scope of this Article: To what extent does bankruptcy law provide the basis for mass treatment of claims via a standardized compensation scheme similar to workers' compensation plans? If such a scheme provides the basis for transaction cost savings, who should benefit from the savings—the firm, its contract creditors and shareholders, or the victims? If the pooling cases the process of presenting claims, should those who would not have sued outside of bankruptcy be compensated at the expense of those who would have brought suit? Must the pooling be done consistently with class action doctrines and precedents? Finally, how should problems of joint liability in industrywide tort disasters be handled?
the Bankruptcy Code along the lines I propose in this Article will allow courts in future cases to deal more effectively with crucial aspects of the problem of bankruptcy and tort than the Code now permits.

I. MASS TORT AND THIN EQUITY: THE CONFLICT BETWEEN UNCERTAINTY IN COMPENSATION AND OPERATIONAL COLLAPSE

Attempts to provide early compensation in a mass tort case would be hampered by the unknown extent of the responsible firm's future liability. Epidemiological studies can provide only a statistical estimate of the firm's probable liability, and identification of the future plaintiffs is impossible. Not only might the statistical studies often turn out in retrospect to be inaccurate, but even on the occasions when they are accurate in the aggregate they will only tell us with great certainty that, for example, one in a hundred of those exposed will contract the disease. But in an exposed population of 100,000, the studies will not tell us which 1,000 will suffer. And until a victim contracts the disease, he or she usually may not sue and obtain damages. Too early a reorganization could both misvalue and misidentify claims.

Yet if the expected claims value exceeds enterprise value, later claimants may find themselves with a lawsuit that, although successful on the merits, would lead to a judgment returned unsatisfied. Matured contract obligations and early tort claims may be paid in full and dividends may be paid to stockholders before doctors correctly diagnose the later victims' symptoms. Furthermore, the firm cannot operate well under a cloud of large claims. The presence of a significant level of contingent liabilities may even bring about the firm's operational collapse. Thus, the paradigm is a tension between the imprecision of present resolution based on unknown future events and values on the one hand, and the operational costs of delay in resolving future claims on the other.

This Part examines the question of whether the basic principles that govern bankruptcy distributions in general apply in mass tort cases. Several of these principles are largely inapplicable. Nevertheless, the danger of the firm's operational collapse indicates that in theory an early reorganization could best maintain the firm's value and thereby, if a practical basis for distribution to the unidentified claimants can be found, best compensate tort claimants in the aggregate.

A. The Relevance of Bankruptcy Principles in Mass Tort Cases

Bankruptcy policy must be examined to determine, first, whether it justifies an early resolution of future tort claims, and second, whether it dictates a specific distributional result. Two core bankruptcy principles, absolute priority and temporal equality, address both the timing and the distributional

13. See infra notes 50–135 and accompanying text.
structure of bankruptcy reorganizations. Absolute priority calls for the compensation in full of senior layers of a firm's capital structure, such as creditors, before more junior layers, such as shareholders, receive anything, at least unless the seniors consent. Temporal equality rejects any first-come, first-served notion. Owners of capital on the same layer are treated identically whether their debt is already due or, absent bankruptcy, would not have become due until the next century.

Distributing the firm's value consistently with these principles often will require an early reorganization. In the absence of an early reorganization, value could be distributed to lower capital layers without leaving enough to pay senior layers in full. Or earlier-claiming creditors could be paid in full, leaving later claimants uncompensated.

Application of these rules is simple if we know the value of the firm and of the claims involved. If tort claimants are placed as unsecured creditors on the firm's hierarchy of capital, they would share pro rata with all other unsecured claimants. If the firm has insufficient value to pay all claimants in full, then shareholders' interests would be eliminated, absent a bargained-for solution. A different situation presents itself when uncertainty surrounds the valuation of future claimants and of the enterprise, as well as the identification of future claimants. This problem might seem to make any effort at current compensation of future claimants unwieldy, perhaps impossible. We will quickly enough examine problems of practicality in Part II. First, we must examine the threshold question of whether central bankruptcy norms justify an early tort-based reorganization at all.

An examination of most of the purported justifications for the core distributional norms of absolute priority and temporal equality—respect for the prebankruptcy bargain, predictability, fairness-as-equality and ordering of an investment market—shows that the validity of applying these rules to justify an early reorganization affecting tort claimants is dubious. A third bankruptcy norm, however—maintenance of the value of the firm's distributable assets, that is, debtor rehabilitation—is relevant to whether there ought to be an early reorganization. When tort claims are a large portion of firm value, this goal becomes so important that it dictates an early resolution of those claims when possible. Debtor rehabilitation, however, does not dictate a particular distributional result.

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Indeed, this principle has been so central to bankruptcy reorganization that at one time case law proscribed distributions to equity holders that deviated from absolute priority even if creditors consented; such distributions were viewed as, in effect, extorted by stockholders through their strategic position to control management during the reorganization proceeding. See Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

As is customary in discussion of absolute priority, and by extension of temporal equality as well, I am not asserting that the system in practice conforms precisely, or even roughly, to the priority and equality norms that can be found in scholarly discussions of general bankruptcy principles and that sometimes can be derived from the text of the statute and leading appellate decisions.
1. Absolute Priority. — Respect for prebankruptcy bargains and facilitation of risk allocation in the prebankruptcy market are interrelated justifications for the rule of absolute priority.16 Facing a firm of uncertain value with an uncertain future, risk-averse investors, if unable to diversify fully, want to be assured to the extent possible that they will be paid in full. Residual equity holders are willing to take the brunt of a disaster. To allocate these risks the way the parties want leads them to bargain for a rule of absolute priority. Refusing to honor their bargain could undermine the goal of encouraging investment in risky but worthwhile enterprises. Moreover, outsiders may find it difficult to evaluate the firm’s prospects. Guaranteeing outside investors a minimum return thus facilitates their investment. Here again, the parties bargain for absolute priority;16 an early reorganization may be necessary to ensure that creditors do not bear the brunt of disaster.

Comparative ease of application also underlies the absolute priority rule. The rule provides some degree of certainty when there is not enough to go around. It establishes a system for valuing and distributing assets, and serves the purpose of loss allocation at least as well as other suggested approaches.17

The weakness of these justifications for absolute priority in the mass tort context is apparent. Tort victims neither bargain for their position nor make a

15. Another justification for the rule is that it helps prevent the firm’s owners from using their control of the firm to divert value from the creditors to themselves. Absolute priority ousts those owners. To the extent this justification is applicable, however, I shall analyze it under the related problem of maintaining firm value via an early reorganization. See infra notes 32–36 and accompanying text. In any case, to the extent that diversion is a problem, it could be resolved by ousting the owners from control, even though they received some value in the bankruptcy distribution.

16. The following example illustrates the point. An oil drilling enterprise has, in the entrepreneur’s view at the time the original investment decisions are to be made, a 50% chance of making $10 million and a 50% chance of making $5 million. The entrepreneur needs $6 million to finance the project. With an expected payoff of $7.5 million, the project seems worthwhile. The entrepreneur, although prepared to gamble on the $10 million payout, has only $1 million to finance the project. Those with the other $5 million could be risk-averse—i.e., very reluctant to take any significant chance of losing part of that $5 million—and unable to diversify adequately. Or they could be unable to assess or manage the risks well. They seem reasonably certain that the project will yield at least $5 million, but they are uncertain whether its upper limit is $6 million, $7.5, or $10 million, or they cannot effectively monitor and control the entrepreneur’s performance to produce the best value from the oil field. One solution is for the outside investor to take debt, a promise to pay $5 million no matter what, with the entrepreneur to take the remainder as equity. If the unfortunate result occurs—a low-yield, $5 million oilfield—bankruptcy’s absolute priority rule provides the creditor with a mechanism for ousting the equity holder and receiving priority in payment.

17. The rule’s most serious conceptual rival—investment value, which values claims by their contract terms and likely payout over time—requires complex valuation of contract terms and the range and probability of future firm value and cash flow. In practice, however, the absolute priority rule may provide just as indeterminate and complex a standard. The relative distribution between senior and junior capital layers will depend on the value assigned to the firm; increasing the value assigned gives less of the firm to the seniors and more to the juniors. Given the uncertainty in valuation and the difficulty of predicting judicial fact-finding on such matters, absolute priority may not in practice provide its purported advantages in facilitating bargaining and reordering of the enterprise’s finances.
voluntary investment requiring an absolute priority rule to facilitate risk allocation. Moreover, regardless of whether valuation is easier under an absolute priority standard than under alternative rules, this factor is of limited significance in a reorganization involving mass tort claims, since the problem of valuing the tort claims is likely to far overshadow ordinary problems of firm valuation. The bankruptcy norm of absolute priority seems to have little if any relevance.

2. Temporal Equality. — The bankruptcy norm of temporal equality requires equal, pro rata treatment among all unsecured contract claims, whether the obligation to repay (i) will arise in the distant future, (ii) arises at the time of bankruptcy, or (iii) arose just prior to bankruptcy.18 Neither having a recently matured and paid claim nor winning a “race to the courthouse” necessarily enables superior treatment.

Two bases for temporal equality—fairness and respect for bargain—best explain the norm’s origin. When there is not enough to go around, many see fairness as equality of treatment.19 Fairness as equality would seem to be even more compelling if long-term creditors have bargained for that equality via default provisions and acceleration clauses, which are nearly universal, central features of long-term lending instruments. If current creditors wanted long-term creditors to wait until current creditors were paid, they could have bargained to obtain such a contractual subordination agreement. In broad outline, the Bankruptcy Code provides for temporal equality, absent bargained-for contractual subordination.20


Some sense of temporal equality as more than abstract principle, as a guide for construction of the Bankruptcy Code, can be gained by examining the legislative history of the Code’s automatic stay, under which creditors are prohibited from seizing the debtor’s property. Bankruptcy Code § 362. The stay was intended not merely to aid the debtor, said Congress:

The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor’s property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor’s assets prevents that.


Presumptions in favor of honoring the bargain or providing equality of distribution, however, are not necessarily conclusive. First, the current Bankruptcy Code sometimes denies creditors their contract right to acceleration and intertemporal equality, pushing the claim back to its original maturity. Second, respect for the bargain is misplaced when the reorganization turns on what to do with involuntary, nonbargain creditors such as present and future tort claimants. Third, the elemental notion of fairness as equality becomes

holders authority apart from bankruptcy law to accelerate maturity and demand immediate payment if the debtor fails to comply with various financial tests. Am. Bar Found., Commentaries on Model Debenture Indenture Provisions 312-470 (1971). Each of the relatively small debenture claimants acts through an indenture trustee in forcing acceleration. Effective enforcement of the Code, see §§303(b), 547, frustrates any attempt by current creditors to profit from an early seizure of firm assets before the debenture-holders' future claims mature, if the indenture had been properly drafted. Similarly, a “race to the courthouse” among current claimants is equally fruitless, since contract creditors usually bargain for cross-default provisions. Am. Bar Found., supra, at 468. These provisions permit those creditors to trigger a bankruptcy and recover for the bankruptcy estate payments recently made to current creditors. Bankruptcy Code §§ 303(b), 547.

This contract-based institution—the bond indenture—should be kept in mind for our examination of the future claimant problem. Recent efforts to structure bankruptcy rules for contract creditors have focused on a hypothetical bargain model, suggesting that the Code begin with a framework similar to that for which the parties would seem likely to bargain most frequently, were it not for the difficulty and complexity of the bargaining process. See Jackson, supra note 18, at 860; Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527, 544-45, 574-75 (1983).

The hypothetical bargain model also seems useful in analyzing the problems of creditors, such as tort creditors, that never bargain with the bankrupt firm at all. Would future tort victims, if they were able to negotiate terms with the firm—to attempt to imagine the nearly unimaginable—not negotiate something quite similar to the pooling, default and acceleration provisions of the typical bond indenture? Would they not name an indenture trustee to act on their behalf? Might the indenture-trustee analogy provide both a conceptual solution to the mass tort bankruptcy problem and perhaps a practical one as well? The possibility of a practical solution through a pooling of claims is discussed infra notes 50-135 and accompanying text; a proposed statutory bankruptcy trigger for contingent claimants patterned after bond indenture covenants is discussed infra notes 231-36 and accompanying text.

21. See Bankruptcy Code § 1124(2) (debtor must recreate predefault setting). This exception to maturing of claims is sometimes more apparent than real, however. The firm does indeed push the claim back into the future, but the claimant may reaccelerate unless the bankruptcy process has eliminated the financial difficulties that permitted acceleration under the indenture. The creditor is not left to flounder uncertain of repayment, or with a reduced claim, but gets reestablished the contractual assurances it bargained for. The creditor, however, is forced to bear the risk that at the time a plan is confirmed the bankruptcy is less able to satisfy the debt than at the time the contract first allowed for acceleration and a cash out.

22. The bargain principle, however, may have some relevance when we are dealing with tort creditors, in light of the hypothetical bargain model discussed supra note 20: if tort claimants could bargain with the firm and its contract claimants, they might get something like a bond indenture. Respect for this hypothetical bargain in a frictionless world might justify an early reorganization with a pooling of claims. This direction of analysis for mass tort reorganizations could be useful, but for the most part 1 will not pursue it in this Article. It would seem to lead to conclusions substantively similar to those that I do reach. See the suggested statutory framework based on minimal indenture covenants discussed infra notes 231-36 and accompanying text.
problematic where nonbargain tort claimants are involved. First-come, first-served distribution has great appeal where the claimants have little control over when to assert their claims. Our society has often been quite willing to spend comparatively large sums to save the current, identifiable victim while underfunding efforts to save the future, statistical victim despite expert consensus that a dollar spent on the former will save fewer lives than a dollar spent on the latter. Perhaps the explanation is that saving the identifiable victim helps preserve a societal myth that life is priceless; to shift a few dollars from the identifiable to the statistical would force an acknowledgment that life indeed has some price. Whatever the explanation, the phenomenon is difficult to deny.

Thus, where involuntary tort claimants are involved, the bargain rationale does not apply, and a decisive argument for an early reorganization to provide temporal equality in compensation cannot be unambiguously derived from fairness principles. It remains to be seen whether a conclusive justification for an early reorganization that could telescope in contingent tort claims can be found.

3. Debtor Rehabilitation: Justifying Early Resolution. — Another basic bankruptcy goal, that of debtor rehabilitation, justifies an early resolution of future tort claims. To preserve the firm’s equity and pay early-maturing claims while huge but future claims hang over the firm could bring about the firm’s operational collapse. Dissipation and diversion of assets are perhaps more likely when the future claims are of scattered, unknown tort victims than when the future claims are of contract creditors that monitor the debtor and have agreements, such as the bond indenture, that facilitate the defeat of efforts to divert assets. As we will see, even absent diversion, the enterprise is likely to be affected severely and adversely. Access to capital markets will be reduced. The enterprise will shrink; contract claims will mature and be paid. Worthwhile projects will be foregone. Stockholders will be motivated to march the firm down risky paths. Customers and suppliers will flee. Mergers will be barred; management, no longer fearful of ouster by merger, might slacken its performance. To the extent it performs, it must donate its time and energy to the resolution of the firm’s financial troubles, not to operations.

23. See G. Calabresi & P. Bobbitt, Tragic Choices 43–45 (1978); infra note 65 (pro rata compensation may be undesirable if it denies all victims adequate medical treatment).

24. Id., at 68, 221 n.3; cf. Zeckhauser & Shepard, Where Now for Saving Lives?, 40 Law & Contemp. Probs., Autumn 1976, at 5, ("Where should we spend whose money to undertake what programs to save which lives with what probability? Ten years ago, merely asking this question explicitly would have seemed unethical or at least repugnant to many, though its central issues . . . were addressed implicitly in a whole range of individual and collective decisions.") (footnote omitted).

An early resolution of a large, contingent tort liability may be necessary, not just to serve distributional norms of creditor equality and priority, but also, as an independent bankruptcy value, to prevent the debtor firm's operational collapse.

B. Unresolved Claims and Operational Collapse

This section examines in detail these operational issues, which are also subtly distributional: the better the firm can operate, the more value it has to distribute.

1. Blocked Access to Capital Markets and Foregone Long-Term Projects. — Consider a firm, its operations worth $2 billion, capitalized with all-equity but with $5 billion in unresolved future claims and debt. How can it raise new funds? Equity financing will be difficult; those who purchase new stock will see their investment either (a) destroyed in a future liquidation of the firm that disproportionately allocates value including the proceeds of the equity investment first to debt layers or (b) dissipated either in operations—which even if successful tend to produce payments to preexisting creditors and tort claimants as they reduce their claims to judgment, rather than to the new shareholders—or directly in payments to preexisting contract creditors and on maturing tort claims. New equity holders cannot get all of the earnings that the firm gets from the new money they provide; those earnings—and often the proceeds of the investment as well—will be diverted elsewhere. The only substantial returns to which they can aspire are interim dividend payments and stock repurchases before the future likely dissolution or reorganization.

New unsecured credit may also be unobtainable or unduly costly. The new creditor will fear that the proceeds of its loan will be diverted to pay maturing claims and prior contract creditors. Compensation from and renegotiation for consensual priority with preexisting contract creditors is at least theoretically possible, although the bargaining may be too complex and costly to actually occur. But compensation from and renegotiation with contingent tort claimants will be impossible because the bargaining costs would be astronomical. The potential new unsecured creditor will also fear that it will not recoup its own investment in a future reorganization, but will have to share those funds with future claimants.

26. Some may desire an early reorganization to compensate tort claimants better or to effectuate tort theories of deterrence. But cf. infra note 203 (suggesting difficulties in implementing such deterrence theories in reorganization).

27. Payment to creditors before distribution to stockholders in a dissolution is the general rule. See, e.g., Del. Code Ann. tit. 8, § 281 (1983); Model Business Corp. Act § 102 (1982). The local law rule in dissolutions predates and is not determined by the absolute priority rule in a chapter 11 reorganization.

28. The new creditor could be given priority by operating the firm in chapter 11 and giving the new creditor noncontractual statutory administrative priority. Bankruptcy Code §§ 364, 505(b)(1), 507. See infra notes 114–22 and accompanying text ("purgatory" alternative).

29. The reader may wonder why the firm seeking new capital does not form a subsidiary that would be insulated from the preexisting liabilities of the parent. Use of a subsidiary, although a
Secured lending provides some basis for financing, because it gives priority to the extent of the security over unsecured creditors, even if the unsecured claims are prior in time. This option faces several potential debilities, however: (a) the firm may have insufficient assets, or assets of the wrong kind, to secure; (b) the firm may find itself in an operational straitjacket if it must grant security; (c) the cash flow burden, when combined with the cash payout on maturing debt, may pose too great a strain on the firm; and (d) preexisting contract creditors, aware at the time they made loans that subsequent secured creditors would obtain priority to the extent of their security, may have bargained for the firm’s covenant not to use security, as they often do. In some circumstances giving the security will be a fraudulent conveyance. These problems will often stymie secured lending.

This inability to raise new funds is not just a technical problem; the firm with large future claims must decline to take worthwhile—perhaps even critically necessary—opportunities, due to financial considerations. Imagine an established mechanical watch manufacturer with large future liabilities at a time when the electronic watch is technologically poised to replace the mechanical. The firm must build factories to produce electronic watches or pay someone else to provide up-to-date supplies. But, barred from access to new funds and having in retrospect overcommitted its funds from earnings to debt service, it is unable to do so. Significant social costs are incurred if the firm, possibility, is not at all a necessarily available one. First, the new funds may not be for a project that is severable from the firm’s ongoing operations. Second, to the extent the new capital is to come in via debt, it is not at all clear that the assets of the subsidiary can with certainty be insulated from the liabilities of the parent. Compare in re Commercial Envelope Mfg. Co., 14 Collier Bankr. Cas. 2d (MB) 191, 197, 201 (Bankr. S.D.N.Y. 1977) (consolidation of related companies permitted because of, inter alia, administrative convenience), and Landers, A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy, 42 U. Chi. L. Rev. 589 (1975) (arguing for generalized consolidation), with Consolidated Rock Prods. Co. v. DuBois, 312 U.S. 510, 520 (1941) (requiring sorting out of liabilities and assets prior to consolidation), and Posner, The Rights of Creditors of Affiliated Corporations, 43 U. Chi. L. Rev. 499 (1976) (arguing against generalized consolidation). Third, covenants in preexisting debt often prevent (1) the transfer to the subsidiary of any of the parent’s assets that may be necessary for the new project and (2) the issuance of new debt by a subsidiary. See Am. Bar Found., supra note 20, at 424-25, 428-29. Fourth, to the extent the capital would be raised via equity in the new subsidiary, the emergence of control blocks may alternatively prevent raising the money on advantageous terms, see generally V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance 689-91 (2d ed. 1979), require the disclosure of proprietary information, or be forbidden by prior debt covenants, see Am. Bar Found., supra note 20, at 428-29.

30. See McDaniel, Are Negative Pledge Clauses in Public Debt Issues Obsolete?, 38 Bus. Law. 867, 867-68 (1983) (clauses limiting company’s ability to create secured debt are the most common covenants in public unsecured debt, found even in high-quality debentures with no other covenants). For example, Manville Corporation had outstanding a significant amount of prior debt that had covenants restricting or prohibiting the incurrence of secured debt. See, e.g., Johns-Manville Corporation and Morgan Guaranty Trust Company of New York, Trustee, Indenture dated as of May 1, 1979, at 25-27 (covering $100 million of notes due 1985).

31. See infra note 210.
with a valuable trademark and a good distributional system in place, were unable to make use of the most current technology. 32

2. Slow Liquidation. — Prior to the advent or recognition of the tort disaster, the firm probably will have contracted for debt with varying maturities and terms. Unable to raise new funds readily in the capital markets, it must divert its cash from operations to make the interest, sinking fund, and principal payments on this preexisting debt. When this diversion is insufficient to make required payments, it must reduce operations—e.g., defer maintenance on the factory—or reduce assets—e.g., sell some of the equipment in the factory—although the operations are worthwhile and the asset disposal operationally unwarranted. 33 Stockholders, fearful of ouster and destruction in the future reorganization, may attempt to divert cash away from operations, maintenance, and investment and to themselves via dividends or stock repurchases. 34 The payoff from better operations and a well-maintained factory would go to the otherwise unsatisfied future claimants, not to stockholders.

32. If the firm could transfer its trademark, distribution system and other assets to a third party with low transaction costs, then the social costs would disappear. Such a low cost transfer is unlikely, however. First, there is no fluid market, like a stock market, in which to sell corporate assets. Second, differing perceptions of value between the firm and the few available buyers could scuttle a deal. Third, it may be impossible to transfer the assets without transferring the crippling tort liabilities as well. See Ray v. Alad Corp., 19 Cal. 3d 22, 560 P.2d 3, 156 Cal. Rptr. 574 (1977); Ramirez v. Amsted Indus., Inc., 86 N.J. 332, 431 A.2d 811 (1981); infra notes 40-44 and accompanying text. This can block the sale. See id.

33. One study concludes that when Manville Corporation became subject to financial stress, it began overcutting its timberland to obtain short-term cash. Indeed, the study suggests that Manville’s management purchased the timberland because of its potential for aiding the company’s short-term cash flow, despite the fact that the purchase price, paid partly in cash and partly in Manville preferred stock, was above “true” value. Asbestos Litigation Reporter (Andrews) 5828-29 (Nov. 26, 1982) (reporting paper by Arthur Sharpelin); see also Manville and UNR House Hearings, supra note 19, at 19-20 (statement of G. Earl Parker, Senior Vice President, Law and Public Affairs, Manville Corp.) (without chapter 11 protection, Manville would “ultimately [be] liquidating assets to keep current”); cf. P. Nelson, Corporations in Crisis 41-42 (1981) (“under extreme adversity, production and long-range marketing concerns often became secondary to immediate improvement in accounting balances to maintain financial support”; plants were allowed to depreciate; the quality of goods sold was lowered; real assets such as plant, equipment and inventories were hastily liquidated at unfavorable prices).

34. In the years immediately prior to its bankruptcy filing, Manville continued paying dividends during a period of declining and eventually negative cash flow. Dividends ultimately exceeded earnings. Rudolph, Why Didn’t the Creditors Notice?, Forbes, Oct. 11, 1982, at 98. While alternative explanations may exist for the change in Manville’s dividend policy, the timing and pattern of the payments suggests the possibility, albeit unproven, of asbestos-related motivations although Manville management has demonstrated a degree of independence from the stockholders, see infra note 202, it may have wished to maintain a good relationship with them; cf. The Manville Bankruptcy and the Northern Pipeline Decision: Hearing Before the Subcomm. on Courts of the Senate Comm. on the Judiciary, 97th Cong., 2d Sess. 13 (1982) [hereinafter cited as Manville Bankruptcy Senate Hearings] (statement of Stephen H. Case, Esq., counsel accompanying G. Earl Parker, Senior Vice President, Law and Public Affairs, Manville Corp.) (Manville’s assets and operations have been reorganized to place asbestos-related assets in a single, separately incorporated entity; question of whether nonasbestos assets and earnings would be reachable by
This factor may be more significant for the owner-managed firm than for the large public firm with management severed from ownership. The management of a large public firm might wish to preserve it over the long-run, if only to preserve their own positions. To the extent that this provided their sole motivation, they would accordingly resist enterprise-threatening diversions of value to stockholders or creditors. But the potential for diversion should not be dismissed as insignificant for the public firm. Management is sometimes effectively controlled by large stockholders even in the case of the large public firm. Management sometimes wants to act in stockholders' interests whether forced to or not. Management may be compensated in stock options dependent upon short-run stock prices, or they may themselves have a large part of their personal wealth tied up in the firm. Management might fear that dissatisfied contract creditors—and contract creditors not receiving current payments will be dissatisfied—will oust management either informally or, should a bankruptcy come to pass, in the course of the bankruptcy reorganization. In any case, previously negotiated contract repayment terms with creditors may confine managerial discretion to run the firm's operations well.

3. Inducements to High-Risk Strategies. — The presence of large future claimants who lack control of the enterprise could induce stockholders—to the extent they are in control—to embark upon high-risk business strategies with a low expected value, as long as the strategy has some chance of providing stockholders with some payoff.37

4. Destruction of Supplier-Customer Relations. — Buyers and sellers that need long-term commitments will be reluctant to deal with a firm under a cloud of large future claims. Ongoing business relationships involve informal but quite real investments in the future of the other party, in information, in developing a working relationship and in physical assets tailored to dealings with the other party. The firm's future liabilities could block these informal and indirect investments. As previously noted, the firm may have trouble financing the commitment in later years. In addition, with respect to formal

future asbestos claimants via consolidation in bankruptcy or otherwise "may become an issue in litigation which [Manville's representatives] would not want to prejudice by discussion [before the congressional committee]"").

35. See, e.g., M. Eisenberg, The Structure of the Corporation 43–56 (1976); Cole, Superior Oil Loses Proxy Vote, N.Y. Times, May 25, 1983, at D1, col. 6 (stockholders of Superior Oil require directors to consider hostile tender offers).


37. For example, assume a firm has $5 billion in future claims and, under one business strategy, an expected value of $2 billion based on a nearly certain $2 billion payoff over time. Stockholders will prefer a second strategy that has a 10% chance of a $7 billion payoff and a 90% chance of a $1 billion payoff. Although the second strategy gives the firm a lower expected value of $1.6 billion ($0.7 billion plus $0.9 billion), it has a 10% chance of giving stockholders $2 billion ($7 billion minus $5 billion), while the first strategy has no realistic chance of providing them with any payoff. Long-term contract creditors attempt to control this tendency towards high-risk business strategies through various loan agreement covenants. When the creditors are tort claimants, no comparable control mechanism exists.
but still executory contracts, the advent of a bankruptcy gives the firm the option to affirm or set aside the contract.\textsuperscript{38} Consumers may be unwilling to buy the firm's products. For example, Lee Iacocca, chief executive officer of Chrysler during the latter stages of its recent financial woes, testified before Congress that a public image of financial uncertainty would result in consumer uncertainty concerning Chrysler's future ability to service warranties and provide spare parts.\textsuperscript{39}

5. Barriers to Worthwhile Mergers. — Mergers can sometimes produce efficiency gains. Integrating production and distribution in one firm may reduce costly contracting across the market between independent producers and distributors. Supervision of employees may be more effective than supervision of outside firms. Free flow of information may facilitate quicker adaptation to changing market conditions; that flow may occur more accurately and quickly within the firm than across the market.\textsuperscript{40} Moreover, some have suggested that, for the large public firm, merger by hostile tender offer provides the mechanism for ouster of slack management. While the evidence is uncertain on whether ineffective management provides a uniform explanation for hostile tender offers,\textsuperscript{41} at least some mergers are probably so motivated.

\textsuperscript{38} Bankruptcy Code § 365.

A domino effect sets in. Customers would cancel their orders. Dealers would lose their ability to finance their own purchases from the factory, which they have to. Suppliers would demand payment for goods in advance, or at least on a C.O.D. basis.

But by far, and most important, the retail customer would worry particularly about future warranty coverage, [about] the availability of parts and service [and] . . . about a big loss in . . . the resale value of his car.

Iacocca seemed to be saying that bankruptcy for Chrysler would have created financial uncertainty and would have resulted in consumer wariness. Such financial uncertainty, however, often will predate a formal bankruptcy, as seems to be so in mass tort disasters. Bankruptcy and early reorganization in these cases could resolve uncertainty, rather than create it.

A desire not to project an image of financial uncertainty perhaps helps explain Manville's schizophrenic public assessments of its future strength. On the one hand, it assures customers of its operational strength. Robart & Joseph, Upbeat Ads from Manville Anger Some, Wall St. J., Nov. 15, 1982, at 31, col. 3. On the other hand, it must convince judicial and political officials that, absent a resolution of asbestos claims in bankruptcy, it will be destroyed. See Kelly, Manville's Bold Maneuver, Time, Sept. 6, 1982, at 17; Wehr, Manville Bankruptcy: Pressure, Action Expected Next Year on System for Compensating Victims of Asbestos Disease, 40 Cong. Q. 2729 (1982).

\textsuperscript{40} See O. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications 35-37 (1975). The opposite may also be true. The point is that even when the parties believe that vertical integration will be most efficient, the future claims will present a decisive bar to a contemplated merger.

Neither type of merger—synergistic integration or managerial ouster—could be undertaken easily when the target faces a large but unresolved future liability. First, the coinsurance effect, by which the acquirer supports preexisting claims against the insolvent acquisition, diverts value from the acquirer. State law rules that provide for successor corporation liability for the tortious liability of the acquired firm contribute to this coinsurance effect. Second, a diversion of value from the acquirer would also occur if the acquirer could manage the acquired firm more effectively. Better management would increase the firm’s value, but that increase would be diverted to pay off more future claims. Unable to capture that incremental value for itself, the acquirer will not take its self-assessed superior capabilities into account in deciding whether to merge. The potential acquirer will view the possibility of these diversions of value as a negative factor when assessing the value of a merger.

Third, acquirors often face an informational debility. The value of future claims is uncertain. Those with the best assessment of value are inside the target firm. Yet they have a motivation to understake the value of such claims if they desire a merger and desire to get the best price for shareholders. Potential acquirors thus will be uncertain of the accuracy of the claims information given them by the potential target’s management, even if management is honest and accurate. This inability to transmit the information credibly may stymie otherwise worthwhile mergers. If the claims were resolved in a bankruptcy, however, this differential uncertainty would dissipate.


43. Aside from the demands of corporate law, the acquirer may expect to have to support the acquired firm’s liabilities, so as to preserve its own goodwill with overlapping suppliers, customers, creditors, or labor unions. Cf. Geremia v. First Nat’l Bank, [1981-1982 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 68,314, at 79,650-51 (1st Cir. June 1, 1981) (parent alleged to arrange subsidiary’s bank credit to enable parent to continue borrowing from their common bank).

44. Cf. S. Myers & N. Majluf, Stock Issues and Investment Policy When Firms Have Information That Investors Do Not Have 1-2, 10-11 (Nat’l Bureau of Econ. Research Working Paper No. 884, 1982) (similar informational disparities cause difficulty in financing new projects). In some sense this question of accurate transmission of information presents a disclosure problem under the securities laws. Management gets a “feeling” that the future will be cloudy. If it gets this from an epidemiological report that concludes “bankruptcy within two years,” the duty to disclose would be clear. If, however, management gets this sense from an intimate knowledge of data that is publicly available but difficult to assess, from the drift and tone of judge and jury in tort trials, or from the wheeze and cough of product users even after the new safety device is installed—then the ability to control and require the information flow is more difficult. Securities law has had difficulty in dealing with such “soft” information. See, e.g., H. Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose 71-74 (1979).
6. Diversion of Managerial Energy. — The management of a firm that finds itself in persistent financial stress will be unable to tend the firm's operations well. Management must help devise litigation strategies, renegotiate loans with creditors, and decide which factories to shut down and what maintenance to defer due to financial not operational needs. It accordingly has less time to devote to basic firm operations. \(^{45}\) Furthermore, current managerial theories suggest that an appropriate "corporate culture" is important to development of a well-run organization. \(^{46}\) The organization that develops a siege mentality, that rewards those who successfully fend off tort claims, whose key employees spend much time talking about how to slip away from the claimants, and whose key employees are demoralized by tort litigation defeats, is not likely to be the organization that develops a functionally useful corporate culture.

C. Resolution in Principle: Early Reorganization and Redistribution of Value

The operational problems that arise when a firm faces a high level of contingent tort liability thus in principle dictate an early resolution of future as well as present tort claims. That a resolution must in principle take place, however, determines neither the distributional result nor the practicality of implementing that result in an early reorganization. Part II discusses the problem of practical implementation under conditions of uncertainty. This Section briefly outlines the distributional framework that I will assume would be put in place in a tort-based reorganization.

1. Resolution in Finance-Based Reorganizations. — How in general does bankruptcy reduce these operational costs? An early reorganization would take place to prevent the operational collapse of the firm; the principles of absolute priority and temporal equality would guide the distribution of value: Once the value of claims substantially exceeds the value of the firm, most or all of the firm's value is distributed roughly on a pro rata basis to the firm's creditors, absent bargained-for deviations. \(^{47}\) When creditors' claims dwarf firm value, the creditors are often given some form of equity in the enterprise,

\(^{45}\) See, e.g., Manville and UNR House Hearings, supra note 19, at 98 (statement of David Leavitt, Chief Executive Officer, UNR Industries, Inc.) ("I have spent a good deal of time involved in exhaustive and expensive legal proceedings relating to asbestos. We are not in business to fight law suits. Our company goal is to provide the best products and services to our customers, to provide a livelihood for our employees and to provide a fair return to our shareholders."); Solomon, The Asbestos Fallout at Johns-Manville, Fortune, May 7, 1979, at 196-97 (chairman of Johns-Manville, an attorney, "spends about half of his time on the asbestos problem"); cf. P. Nelson, supra note 33, at 42, 56 (empirical study of firms under financial stress; ";executive time was not shifted to consider basic problems, but instead was expended assuaging creditors and providing guarantees to customers; and to the extent some basic problems were attended to, long-range and strategic planning was ignored).

\(^{46}\) See generally T. Deal & A. Kennedy, Corporate Cultures (1982).

\(^{47}\) Creditors might give equity-holders something for the nuisance value of their claims, to prevent the equity-holders from forcing a complex valuation hearing that might overvalue the firm to the equity-holders' benefit and that would in any case result in costly delay.
so as not to overwhelm the firm's operations with debt. The firm is then discharged on its debts; the large cloud of claims is removed. Operational collapse under the strain of too many claims is avoided.48

2. A Mass Tort Distributional Framework — Debtor rehabilitation suggests an early resolution in mass tort cases but it fails to dictate a specific distributional outcome. The bargain-based rationales for absolute priority and temporal equality as a distributional framework have little relevance in tort-based reorganizations. I assume, however, that a court overseeing an early reorganization would not discharge the firm's liability and leave the contingent tort claims unpaid, but would seek to give the tort claimants about the same pro rata compensation that they would have received from the continued enterprise absent diversions of value of detrimental operational effects. Although I will make no effort in this Article to justify this manner of early resolution, it might be based, first, on fairness and risk-allocation values derived from tort law, and second, though more equivocally, on the sense of fairness-as-equality that in part underlies bankruptcy's equal treatment of most creditors.49

There is, I suppose, a biblical irony in the result to which we are driven if we combine the principles of debtor rehabilitation, equality among creditors (including tort claimants), and priority of creditors (including tort claimants) over owners. Telescoping future claims into an early reorganization makes the mass tort victims of a firm's misdeeds the firm's owners. A sine qua non of this irony is more modern in origin: Capital in the modern public corporation is or often can be severed from the day-to-day management of the firm. Whether the issue is the impossibility of complete shareholder democracy or the potential slackened efforts of uncontrolled managers, this untying of management from ownership has been a central, often lamented concern of corporate law. Yet a corollary of this unbundling is that capital may be

48. This is not to say that all possibility of an operational collapse would be avoided. The firm may have gotten itself into difficulty because the demand for its product declined, because of new technologies that made the firm's production process obsolete, because of bad management, because of poor labor relations, or because of other matters not directly associated with the firm's capital structure. The point is that a likely barrier to operational recovery would be removed. Financial strength does not assure operational success.

49. Although this Part of the Article deals primarily with the bankruptcy policy implications of mass torts, we can note that this result roughly corresponds with the Code's distributional framework for contract creditors, current tort creditors and stockholders. Whether contingent future tort claimants are creditors within the meaning of the Code is at this time an unsettled question. See infra notes 136-61 and accompanying text.

Under the Code secured creditors receive payment in the full face amount of their claim, to the extent of the value of their security; the unsecured contract claimants, tort claimants and shareholders divide what is left. Bankruptcy Code § 1129(b)(2)(A). The question of the proper distributional relationship between tort and secured creditors is not a subject of this Article. Those interested in that relationship should see Schwartz, Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 J. Legal Stud. 1 (1981) (economic theory provides conflicting explanations of secured debt); Schachman, An Attempt at "Philosophy of Bankruptcy," 21 UCLA L. Rev. 403, 444-49, 475 (1973) (moral worth of creditor's claim as basis for priority).
displaced without necessarily destroying the firm's operations. When future tort claims dwarf firm value, the modern corporate structure and basic bankruptcy principles permit the owners of some or all of the public firm's capital to be joined or replaced by the tort claimants. 50

II. PRACTICAL APPLICATION OF BANKRUPTCY POLICY: ACCOMMODATING UNCERTAINTY

Can a telescoping of future tort claims into an early reorganization to relieve the operational pressure be accomplished on any practical basis? Contract creditors are usually readily identifiable; their claims are usually reducible to clear amounts. Unlike them, contingent tort victims present obvious practical difficulties in identification and in valuation and compensation of their claims. Their contingent claims may have arisen, for example, from exposure to carcinogens that may not lead to malignancy, and that, if it does, will produce unpredictable damage within any of the next twenty years. The form that compensation should take would present practical problems as well, since stock would be difficult for individual tort claimants to use effectively. Yet compensation from the bankrupt firm in cash or deferred payments could lead to the very risk of operational collapse that we have been seeking to avoid, since it is principally the aggregate size of the claims that creates the risk. 51

In In re UNR Industries, Inc., 52 the first court to face the issue, apparently concluded that no practical framework could be found that would allow for an early resolution of a large, contingent tort liability. 53 This result makes it important to demonstrate that at least one set of practical devices exists that will permit a telescoping of future tort claims in an early reorganization.

The tort claims could be pooled in a manner similar to that used in pension funds. Identification of the individual claimants at the time of reorganization would be unnecessary; only the probabilistic value of the aggregate claims must be determined. Others have proposed that some sort of cash

50. The severity of these operational costs will vary from bankruptcy to bankruptcy. Every proposed solution will entail transaction costs. Leaving aside the desirability of furthering a particular distributional result, whether the operational costs of delay would exceed the net transaction costs of resolution will determine whether an early resolution is worth pursuing. The approach to be taken here will assume that operational costs of delay exceed net transaction costs.

51. See, e.g., Blum, Corporate Reorganization Doctrine as Recently Applied by the Securities and Exchange Commission, 40 U. Chi. L. Rev. 96, 96-97 (1972); Roe, supra note 20, at 549-58; supra notes 27-46 and accompanying text.


53. See id. at 744 ("The Application raises various statutory, practical, and constitutional problems."); see also Note, Mass Tort Claims and the Corporate Tortfeasor: Bankruptcy Reorganization and Legislative Compensation Versus the Common-Law Tort System, 61 Tex. L. Rev. 1297, 1335 (1983) (arguing that it is impossible to "provide adequate compensation for a class of future claimants in a bankruptcy payment plan"). It may have been these practical difficulties that led the UNR court to interpret the Bankruptcy Code to deny the possibility of present resolution of large aggregate future claims. See 29 Bankr. at 742. The case is discussed further infra notes 136-86 and accompanying text.
compensatory pool be created to deal with aspects of the asbestos problem. But their proposals differ radically from the approach that I take in this Article. These other proposals are designed principally to reduce the transaction costs of tort litigation; they rely for authority on consensual bargaining or new legislation; and they would fund the compensatory pool principally through intermittent cash payments from the several asbestos manufacturing firms. To summarize what is to come, I suggest that a basis for pooling arises from the strong bankruptcy norm of debtor rehabilitation and the weaker norm of creditor equality in tort-based bankruptcies; authority derives from the Bankruptcy Code; and funding would initially be in common stock of the bankrupt firm.

Further practical problems arise in determining a method of compensating claimants from the pool. Two oft-suggested means would make pro rata lump-sum payments after litigating the issue of injury or pro rata lump-sum payments based on a schedule of injury similar to that used in many workers' compensation plans. These proposals, however, do not accommodate uncertainty concerning likely changes in aggregate claim value over time. If there is a serious possibility that the value of claims will greatly exceed the value of the enterprise, using these methods will result in substantial disparities in the compensation received by earlier claimants in comparison to later claimants. Administering the pool in a manner analogous to the variable annuity will best accommodate this uncertainty. These issues of pooling, uncertainty and administration are complex and require detailed discussion.


While this Article was in galleys, one group of Manville Corporation creditors proposed compensating tort claimants via a trust of Manville stock. See N.Y. Times, Mar. 23, 1984, at D3, col. 6.


56. This problem of over- and under-compensation, sometimes referred to in this Article as the over/under problem, has several configurations. The distributional result of an early reorganization could lead to at least three misdistributions, viewed in retrospect. First, the tort claimants can be miscompensated inter se, as between earlier and later claimants, if the later level of aggregate claims exceeds that expected during the reorganization. Second, tort claimants can be miscompensated in comparison with contract creditors, if the future values of contingent claims and the firm deviate from those expected at the time of reorganization. Finally, too little or too much could be taken from stockholders, again if future values turn out differently than expected.
A. The Pension Fund Analogy

A simple hypothetical will highlight several problems of practicality and uncertainty. Assume that there is a reasonable certainty that 10,000 tort victims will assert $5 billion in tort claims against the enterprise. The firm has no contract creditors and is worth $2 billion, absent the tort claims. How can the 10,000 as-yet-unidentified claimants be compensated? If the firm, for example, had negligently exposed 100,000 workers to carcinogens, but only one out of ten will get the disease and incur $500,000 in damages, resolution in an early reorganization could compensate each victim the likely damages ($500,000) discounted by the probability of occurrence (10%). But it seems silly to compensate each employee $50,000 when nine out of ten will go unharmed and one will be harmed. Nine would receive a $50,000 windfall; one would be damaged $450,000 more than compensated. If the liability were expected to arise from a product in use, then everyone, not just an identifiable pool of past or present employees, may be a potential user or victim. The potential victims of poorly designed automobiles, for example, include not only their owners but other drivers, passengers and bystanders as well. Does it make any sense to think about compensating each current and future motorist and passenger a couple of dollars?

Moreover, the immediate compensation of at-risk individuals, many of whom may never be damaged, is unnecessary. As long as the reasonably likely extent of aggregate liability ($5 billion in present value) is determined to exceed the enterprise's present value ($2 billion), then the $2 billion in value could be turned over to, for example, an insurance company to manage and distribute as the injured are identified in the future. Similar aggregate payments are now made by firms to large pension funds without certainty about which individuals will make claims on the fund in later years. Current, individualized identification and compensation are unnecessary for either the pension fund or the tort claimants' fund. The manager of the tort claimants' pool of assets would be instructed by the court to pay out 40% ($2 billion in value, divided by $5 billion in expected claims) of each appropriately presented claim.

57. The over/under problem will arise whenever future probabilistic outcomes are reduced to their expected values. Since uncertainty about future enterprise value is always present in chapter 11 reorganizations, the over/under problem is always present. As suggested infra text accompanying note 86, in financial reorganizations there are ways to deal with, or bases for ignoring, this over/under uncertainty. Tort reorganizations, however, cannot be similarly resolved, nor can the over/under problem be so readily ignored. See infra notes 86-87 and accompanying text.

A compensation scheme that ignores the over/under problem would not seem so foolish if each compensated claimant could insure against the financial losses that he would incur if the disease did develop. See Note, Procedures, supra note 55, at 172. But it is hard to believe that individual claimants can obtain that kind of insurance knowledgeably and at low transaction costs. See infra notes 111-14 and accompanying text. The obvious solution is for the court to pool the “insurance premiums” for the ten individuals subject to risk, and allow the one victim to draw down the $500,000.
As previously noted, some have proposed to “solve” the problem of asbestos compensation by use of a fund from which tort victims would be paid on a lump-sum, pro rata basis. The proposals contemplate, however, that the fund be financed out of the defendant firms’ ongoing earnings.\(^5\) We can now see that these proposals are fundamentally flawed. A fund financed in this way would be little different from a financing based on long-term debt, or preferred stock, with a sinking fund or staggered maturities. Claims in any year could exceed that year’s earnings. Since the present value of obligations to the fund will often be a substantial portion of the bankrupt firm’s current value—otherwise, reorganization in bankruptcy is unnecessary—the firm cannot easily provide the cash immediately. Instead it must pay the cash over time, perhaps annually, as claims are expected to be asserted. A lid on the size of the annual payment would then be necessary, whether that lid be a fixed sum, actual earnings, or actual cash available; unless partial liquidation were contemplated or access to the financial markets assured, it could not be more than the cash the bankrupt is able to generate. To the extent that this high debt level is fixed, it creates many if not all of the operational risks due to large unresolved claims.\(^6\) Nor is it at all certain that this kind of cash funding would be permitted under the Code.\(^6\) If aggregate claims are high, one must find a mechanism to give the shareholders’ ownership interest to those with the greatest claim on the firm’s earnings, to be consistent with sound financial policy and bankruptcy law. Proponents of the fund theory have failed to do that. At best they have “solved” a different problem: how to deal with significant contingent claims that are a small fraction of firm value. A high claims level, if compensated via a cash fund, would entail a tension between...

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\(^5\) See supra notes 54-55 and accompanying text; Stockholders & Creditors News Service Re Johns-Manville Corp. (Andrews) 1615 (Oct. 31, 1983) (statement of Judge Edelstein) (“[I] would like you to consider . . . the creation of a twenty year sinking fund [to pay] future claimants as their claims are liquidated.”) [hereinafter cited as Manville Reporter]; Note, Manville Bankruptcy, supra note 55, at 1130; cf. [Proposed] Plan of Reorganization at 1, 3-4, 8, 23-25, 29-30, in re Johns-Manville Corp., Nos. 82-B-11656/11676 (Bankr. S.D.N.Y. Nov. 7, 1983), reprinted in Manville Reporter, supra, at 1746-47, 1749, 1761-62 (Nov. 28, 1983) (asbestos claimants to be paid by successor entity funded in part by payments from a separately incorporated operating entity); Manville and UNR House Hearings, supra note 19, at 107 (question of Rep. Johnston directed to UNR representative) (inquiry whether it is wiser to require UNR to make “a significant capital contribution or principal payment [or] . . . a stream of periodic payments going into the future”; no clear response). Although Manville has in form withdrawn its motion to have future claims resolved in a class action, Plaintiffs’ Response to Motions to Dismiss and Suggestion of Mootness, at 2, in re Johns-Manville Corp., 3 Bankr. L. Rep. (CCH) ¶ 69,615 (Bankr. S.D.N.Y. Jan. 23, 1984), its plan of reorganization clearly would affect the future claims as if they were represented as a class. See Plan of Reorganization at 1, 8, 29-30, in re Johns-Manville Corp., Nos. 82-B-11656/11676 (Bankr. S.D.N.Y. Nov. 7, 1983), reprinted in Manville Reporter, supra, at 1746, 1749, 1761-62 (Nov. 28, 1983).

\(^6\) Bankruptcy Code § 1129(a)(11) (requiring firm viability as a prerequisite to plan confirmation).
the operational risks that might arise if the obligation to pay cash is high and the undercompensation that might result if the obligation is low.

Moreover, immediate funding via a pool of the enterprise's common stock, representing the firm's value, has significant benefits for claimants. Compensating claimants from the firm's future earnings subjects them to the risks of a highly variable source. Pooling and early reorganization do not have this debility. While initially the assets of the pool would be stock of the bankrupt firm, they need not remain so. For example, imagine a reorganization of Manville Corporation along these lines, with the claims and enterprise values previously assumed. Manville stock, worth perhaps $2 billion, would be turned over to, say, Aetna to manage for current and future victims. Manville's current value of $2 billion might be an averaging of a .5 chance of being worth $3 billion over the long-run and a .5 chance of being worth $1 billion. The amount of cash available for compensation would be highly variable, dependent as it would be on a single enterprise's earnings capacity.

To help assure the continued existence of the $2 billion pot for payout, Aetna would presumably sell Manville stock into the market, using a small fraction of the proceeds to pay current claimants and the remainder to diversify. In time, the makeup of the investment pool may have only a historical relationship with Manville. The advantage to claimants of diversifying the

61. See supra notes 27-46 and accompanying text.
62. This conclusion may indicate that the failure of Manville management to seek the outcome that I suggest here, see Plaintiff's Class Action Complaint for Estimation of Contingent Unliquidated Asbestos-Related Health Claims, at 4 & Attachment A, In re Johns-Manville Corp., Nos. 82-B-11656/11676 (Bankr. S.D.N.Y. Feb. 3, 1983), is not based on a lack of imagination. Rather it may spring from some residual economic ties to shareholders and on a managerial desire not to see current shareholders—whom management is comfortable—displaced. If the claims pool captures only a fraction of firm value and is funded in cash instead of stock, the reorganization plan will help maintain the current shareholders' position and managerial control to a greater extent than would the common stock plan set forth in this Article.
63. The same result could be reached by selling either the bankrupt firm's operating divisions as going concerns, or securities representing 100% ownership of the firm's operations without any liabilities, and using the proceeds for the claims fund. Bankruptcy courts have hesitated to use such sales, in the apparent belief that the market undervalues the assets, operations and securities of bankrupt firms. Indeed, bankruptcy institutions have used liquidation sales and going-concern reorganization as polar concepts, when in fact they are not. See, e.g., Clark, The Interdisciplinary Study of Legal Evolution, 90 Yale L.J. 1223, 1250-53 (1981) (tracing evolution of distinction): Jackson, supra note 18, at 893-94. Operating divisions can be sold as going concerns; if sold quickly, the sale could be called a liquidation.

I argue in this Part of the Article that an early reorganization could occur without a liquidation that—as bankruptcy institutions assume—would not reflect going concern value. Elsewhere I have maintained that this premise of ineffective marketability must be reexamined for public firms, in light of recent evidence and theory on the nature of the market for bankrupt's securities. Roe, supra note 20, at 559-80.

If in the context of a tort-based reorganization one were to reexamine this assumption of the effect of a going-concern liquidation, several considerations should be kept in mind. First, I based my earlier argument for a reexamination in part on the enhanced importance of speed and the diminished need for accuracy in the usual finance-based public firm reorganization, in which the firm's owners usually have diversified their holdings. Roe, supra note 20, at 538-45, 562 n.124.
claims’ pool is not trivial. Many will look to the fund to pay for medical treatment needed to prevent their ailment from worsening. Greater certainty of compensation will tend to reduce such secondary costs. This advantage is insignificant in the more usual contract-based reorganization. Contract claimants can diversify their investments so that the variance in compensation from the bankrupt firm is not crucial. Tort claimants, however, are less likely to have that capacity.

But the value of accuracy is heightened in a tort-based reorganization. See infra notes 87–88 and accompanying text. Accordingly, one would have to address directly the question which mechanism will most accurately value the firm: the market, the bargained-for reorganization plan, or the bankruptcy court itself.

Second, we do not as yet have enough experience with billion-dollar common stock underwritings, see Roe, supra note 20, at 559, 573; Karlin, Britain’s Plan to Sell Phone Monopoly Stock Sets Off Sharp Debate, Wall St. J., Jan. 30, 1984, at 1, col. 6 (largest American underwriting to date was a $1.17 billion offer of A.T. & T. common stock), to allow us to conclude that quick, immediate sales of securities representing the entire ownership of a multi-billion dollar company could be accomplished effectively. But intermediate solutions—for example, partial stock sales over time or sales of operating divisions—may be plausible.

One factor might make an operating division liquidation more plausible in tort-based reorganizations than in finance-based reorganizations. Ordinarily, the value of superior management—if it exists—might weigh against such a sale, since selling off operating divisions will fragment management and thus may destroy its value as a team. But in mass tort cases, management’s crucial skills probably would be its ability to control the fires of litigation; indeed, management may have been selected for that ability. These skills would become superfluous in the reorganized firm; the raison d’etre for early reorganization is to put out those fires.

On the other hand, managers may resist liquidation more tenaciously in a mass tort reorganization. Their litigation-oriented skills may be less transferable than other managerial skills. They especially may want to continue their association with the firm if they personally have become defendants in the litigation, to make sure that they receive indemnification and legal representation.

Finally, a shift from reorganization in chapter 11 to going concern liquidation in chapter 7 could shift the framework of creditor distribution, creating further conflict in the reorganization. Compare Bankruptcy Code §§ 502 (b), 726 (valuing claims at face value in liquidation), with id. §§ 1129(a)(3)(B), 1124(2) (circumstances under which face value of claim not given).


An examination of the tort claimants’ risk preferences and diversification capabilities would open up yet another dimension of complexity and uncertainty. It is one thing to point out the relative diversification capabilities of contract and tort creditors as well as the important secondary costs that tort claimants are likely to incur if uncompensated—for example, the tumor untreated due to insufficient funds may become untreated, even if funds later become available. But if we were to examine risk preference and diversification capability in compensating tort claimants later, we would face serious problems. Suppose the aggregate compensation for a curable disease is 40% of each claim, an amount inadequate to provide a complete cure. If none of the victims have sufficient other resources to make up the needed 60%, it may be preferable to compensate some in full and others not at all. At least some victims would then be cured. If so, the consideration of fairness-as-equality that I have assumed would inform a bankruptcy distribution would be undermined. Indeed, the first-come, first-served ethic may then provide a better
B. Uncertain Aggregate Claims and Firm Value: The Variable Annuity Analogy

A significant difficulty in implementing the pension fund analogy arises if we drop our assumption of reasonable certainty of aggregate claims value. What if we cannot be certain that claims in the aggregate will be $5 billion? What if they may be $3 billion, $5 billion, or $10 billion, each with equal likelihood? The problem now is obvious: To choose a $5 billion claim level that turns out over time to be $10 billion will overcompensate early claimants and leave later claimants with nothing. Pooling of claims so that they draw compensation through pro rata lump-sum payments from a pool initially composed of the bankrupt firm’s common stock helps free the firm from operational debilities. But it does not account for the uncertainty that could easily lead to widely varying compensation to claimants.

The problem of erroneous compensation, viewed in retrospect, could also arise from uncertainty concerning firm value. So long as the claims fund has not been diversified by selling the stock received from the firm and reinvesting the proceeds, pool value will track firm value. If at the time of reorganization it appears that over the long pull the firm may be worth $1 billion, $2 billion or $3 billion, each with an equal likelihood, the potential for severe under- or over-compensation would also arise—and would only be reduced, not eliminated, when a less-variable, diversified pool is in place. On the numerical assumptions involved here—an enterprise value that could vary between $1 billion and $3 billion, and aggregate claims that could vary between $3 billion and $10 billion—the proper payout ratio could vary from 10 cents on every $1 claimed to a full, dollar-for-dollar payout. Even a pool of diversified stocks will vary in value over time. A practical telescoping of the claims must somehow accommodate this uncertainty in aggregate claims and firm (or pool) value.

basis for allocating the scarce resource. See generally G. Calabresi & P. Bobbitt, supra note 23. Or if the distribution of other resources is uneven, then perhaps a needs test is best.

Furthermore, when medical risks replace contract rights in reorganization, the unknowns involved can severely shift the value of the dollars actually paid in compensation, due to the inability to diversify the risks. For example, a slight and unexpected increase a decade after reorganization in the general environmental level of carcinogen exposure may greatly increase the incidence of cancer in those tortiously exposed to a carcinogen by the bankrupt firm. The compensatory fund may thereby be stretched so thin that it can at that later date provide little more than token compensation, although earlier victims were paid nearly in full.

We need not now deal with the difficulties of compensating the tort victims inter se, however. The relative ability to diversify can support conclusions about which group of creditors can better bear the risk of deviation from averaged, expected outcomes in the reorganization without requiring the inter se solution to be determined. The difficulty must be faced only in those instances when the two following decisions interact: when the decision to create a compensatory pool dictates a decision to treat tort claimants on a pro rata rather than a first-come, first-served basis. The first decision might dictate the second because the creation of the fund would draw attention to the noncompensation of later victims, so that they could never be completely abandoned.

66. More realistically, the expectations will vary along a continuum such as that of the familiar bell curve. I use three specific values to simplify the arithmetic examples used later in the Article.
1. The Variable Annuity Analogy. — The problem of uncertainty of payout to victims can in large measure be controlled by use of a payout method similar to that of the variable annuity. When purchasing a variable annuity, the investor purchases “shares” of units of a pool of stock. The seller—typically an insurance company—promises to manage the investment pool and pay the investor back an equivalent number of shares at a later period, or a few of the purchased shares in each of several years. At the time of payback the shares may have risen or fallen in value, depending upon the level of the stock market and the insurance company’s success or failure in picking stocks. 67

Use of a mechanism analogous to the variable annuity can reduce the risks of mistaken distributions due to a changing firm or pool value. Recall the posited uncertainty about future firm value (on which the value of an undiversified pool depends in its entirety): $1 billion, $2 billion or $3 billion, each with an equal likelihood. Similarly, the future value of a diversified pool will be uncertain. 68 Assume now that it is reasonably likely that claims have a value of $6 billion. “Shares” in the claims fund could be assigned based on the dollar value of a claim. For example, if there were $6 billion in claims, 6 billion fund shares would be issued. Claimants due $100 million currently would receive 100 million shares. The $5.9 billion of expected future claims would be accounted for by reserving 5.9 billion shares. Next, an assumption regarding firm or pool value would be made to allow “redemption” of the 100 million shares by the current claimants. 69 Suppose that the expected firm value, or the market value of a diversified pool, is $2 billion. The payout ratio (pool value divided by estimated claims) would be .33 at the time of reorganization. If the value remaining in the pool dropped to $1.5 billion after $600 million in claims had been paid, the payout ratio would be changed to .28 from .33, so that a share would be redeemed for $0.28.

Since the claim of, for example, a 50-year-old disabled worker would often be for ongoing medical expenses and lost future compensation, many such “current” claimants could be paid in annuity, rather than lump-sum form. That is, instead of receiving a lump sum of 60,000 shares (worth $20,000 based on a $60,000 award at a .33 payment ratio), the worker would receive 6,000 shares in each of the subsequent 10 years. 70 As such, the annual

68. The current value of the diversified pool presumably would be its current market value, a number easily calculated. The problem of uncertainty is that the stock market will fluctuate, making future value different from current value, even if current value is the expected future value.
69. In practice, there would be little reason for issuing and redeeming shares; bookkeeping entries would suffice and be administratively cheaper. I use notions of share issuance and redemption only to illustrate the parallels between the proposed solution and the variable annuity, an institution now in place and widely used.
70. This disbursement would be adjusted for the time value of the delay, of course. If there were uncertainty in damage, because, say, asbestosis sometimes but not always turned into
“redemption value” for claimants could be adjusted as one acquired new information about firm value, or about pool value as the “trustee” diversified. In addition, given the new information, one could consider adjusting the payout to prior claimants who were over- or under-compensated.\textsuperscript{71}

Use of the variable annuity analogy in place of pro rata lump-sum payments at the time of proof of injury would not only control administration of the problem of uncertain future firm or fund value, but also—and perhaps more importantly—would help reduce the over/under problem arising from an uncertain level of claims. We said that claims were not reasonably certain to be $6$ billion, but rather could be $3$ billion, $5$ billion or $10$ billion, with equal likelihood. This additional level of uncertainty could be treated as a second variable in the variable annuity analogy. Assignment of fund shares at one share per dollar claimed would be based on the current best estimate of claim value—here, $6$ billion. Since initially firm value was determined to be $2$ billion, one-third of the best estimate of aggregate claims, shares would be redeemed at $\$0.33$ each.\textsuperscript{72} As new estimates of aggregate claims were made with later information, the payout ratio could be adjusted to account for the change in the level of expected claims.

Alternatively given vast epidemiological uncertainty, conservative pool management might base that assignment on the highest reasonably likely claims value, rather than the current best estimate.\textsuperscript{73} Although the best-estimate approach seems preferable,\textsuperscript{74} the method of valuation adopted is not

mesothelioma in later years, then a second look might be taken later. If the more serious disease developed, the worker and his family would get an additional allotment of shares. But see infra note 77.

\textsuperscript{71} When the ratio changed from .33 to .28, prior claimants became over-compensated in light of the pool’s new value. One could either ignore this effect or adjust the current redemption value of their claims downward. Recovery of overpayments from claimants who are no longer drawing from the pool would probably be administratively infeasible and in any case would clash severely with the norm of repose.

\textsuperscript{72} \text{Redemption value} = \frac{\text{Pool Value} \times \text{share's nominal value}}{\text{Expected Aggregate Claims Value}}

\text{=$2$ billion \times $1.00 = $0.33$ per share, $6$ billion}

\textsuperscript{73} For example, some have concluded that the most likely aggregate industry-wide asbestos-related liability over the next few decades is $38$ billion. But the lowest plausible liability is estimated at $8$ billion, while the highest plausible liability is $87$ billion. P. MacAvoy, J. Karr & P. Wilson, supra note 4, at 1-2--1-3.

\textsuperscript{74} Cf. infra notes 187-236 and accompanying text (reorganization should proceed if best guess is that aggregate contingent claims represent a large portion of firm value). The best estimate may be little more than a guess by scientific experts, since epidemiological projections often may be highly imprecise. The point of this variable annuity discussion is that there are practical bases to accommodate that uncertainty; the payout ratio can be adjusted as new epidemiological evidence becomes available.
particularly crucial. Adjustments may be made as time goes on. That is, after some short interval, perhaps one year, the pool could be revalued and the redemption value changed. Perhaps after one year pool value could be recalculated, let us assume again to $1.5 billion, and claims value would be reestimated. If at this later time, claims seemed equally likely to be either $2 billion, $3 billion or $4 billion, the payout ratio would be changed to $0.50 per share.75

2. Illustrating the Accommodation of Uncertainty. — To see how the variable annuity analogy helps accommodate uncertainty about the value of future claims posit the following. A, B and C have been negligently exposed to a disease-causing drug. A comes down with the disease and suffers damages of $750,000, representing reduced earnings capacity and increased medical expenses. B and C were exposed at a later time than A. If they also eventually get the disease, they will come down with it within the next few years, and also incur damages of $750,000 each. In each case, however, there is only a 50% chance that the individual will contract the disease. The compensation pool from which all three will draw is worth only $1 million.

If A receives compensation in a lump sum based on expected value, A takes $500,000 now.76 If B and C then come down with the malady, they will obtain only $250,000 each, although each has damages equal to A's. There is a 25% chance that this will happen. There is also a 25% chance that neither B nor C will be afflicted, in which case A would have been undercompensated from the $1 million available. A will be "properly" compensated only if allowed to draw upon the fund a second time.

A could instead be compensated with an annuity for A's reduced earnings capacity for the 25 years A expects to work as well as for continuing medical expenses. A would have an annual claim of $30,000 ($750,000 spread over 25 years), present value adjustments aside.77 The $1 million compensation fund has $40,000 to distribute in each of 25 years. Since A has half of the expected aggregate claims, A may take an annuity representing half of the $40,000


76. The present value of expected future claims is $750,000, as is the value of A's present claim. A's claim being half of the total expected claims, he is entitled to take half of the $1 million compensatory pot, leaving half for the future claimants.

77. This annuity is to be distinguished from varying the periodic annual payments in tandem with the actual damages suffered, to reflect the actual reduction from present earnings and medical expenses actually incurred. The latter approach might be advantageous, in that it could provide a more finely-tuned compensation than the annuity alternative. It would, however, suffer from a few defects. First, to readjust damages would require additional paperwork and monitoring to assure the accuracy of the claims, creating additional administrative costs. Second, readjustment would introduce a moral hazard risk: Since claimants would be guaranteed some portion
of their income and medical expenses, their incentive to maintain employment skills and keep medical expenses down would be reduced. See generally Rea, Lump-Sum Versus Periodic Damage Awards, 10 J. Legal Stud. 131, 135-36, 144 (1981) (arguing that periodic contingent damage payments in some circumstances would add substantial costs to existing costs of accidents). Either type of periodic payment could evoke opposition from the plaintiffs' bar, if it affected the fee structure of plaintiffs' counsel. See id. at 146 & n.45.

78. The same result can be reached by annualizing the redemption value formula set forth supra note 72.

79. I have not generally made present/future value adjustments to claim value here or elsewhere in the Article, since to do so would needlessly complicate already complex numerical examples. In the example at hand, I have also ignored the fact that the compensatory pot has been reduced to $980,000 by the time of the second-year payout, since the first-year payout is larger than it "should" have been with the benefit of hindsight. Nor have I accounted for the undistributed $20,000 from the first year. Again, to make these adjustments would do nothing to clarify the conceptual problem.

The examples I have discussed in text deal with a single firm and a single bankruptcy. Tort disasters may be industry-wide problems, as they have become in the asbestos and DES disasters. Tort law accordingly has accommodated those plaintiffs' inability to identify the particular firm responsible for their injuries. Industry members have been joined as codefendants, with damages allocated in proportion to the defendant's market share unless a lack of causation is shown. See Hardy v. Johns-Manville Sales Corp., 509 F. Supp. 1353, 1357-59 (E.D. Tex.), rev'd on other grounds, 681 F.2d 394 (5th Cir. 1982); Sindell v. Abbott Labs, 26 Cal.3d 588, 611-13, 607 P.2d 924, 937, 168 Cal. Rptr. 132, 144-45, cert. denied, 449 U.S. 912 (1980). But see In re Related Asbestos Cases, 543 F. Supp. 1152, 1158-59 (N.D. Cal. 1982) (declining to allocate damages based on market share because of difficulty of ascertaining market share and because plaintiff had some information on the identity of the defendant responsible). Joint liability could create inconsistencies between the compensation methods for the portions of a claim allocable among bankrupt and
ascertained, tort claimants or shareholders\textsuperscript{80} may be found to have been proportionately under- or over-compensated to a significant extent, viewed in retrospect.\textsuperscript{61}

A numerical example will illustrate the problem. Future firm value will be \$1\ billion, \$3\ billion or \$5\ billion, each equally likely. Aggregate claims will be \$1\ billion or \$3\ billion, each equally likely. The average expected values thus are \$3\ billion in firm value and \$2\ billion in claims. An award based on these expected values would give two-thirds of the firm to the victims. But an award of the firm’s equity based on these expected values will \textit{never} lead to a perfect fit between compensated aggregate claim value and firm value, viewed in retrospect. On these numbers, there is a fifty percent chance of the error reaching or exceeding \$1\ billion.\textsuperscript{62} This Section addresses the question of how and to what extent an early reorganization may proceed while minimizing this disparity.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Actual Value of Firm} & \textbf{\$1 billion} & \textbf{\$3 billion} & \textbf{\$5 billion} \\
& (33\% chance) & (33\% chance) & (33\% chance) \\
\hline
$1$ billion & $0.67$ billion & $2$ billion & $3.3$ billion \\
(50\% chance) & ($0.33$ billion & ($1$ billion & ($3.3$ billion \\
& below best & above BPF) & above BPF) \\
& possible fit (BPF) & & \\
\hline
$3$ billion & $0.67$ billion & $2$ billion & $3.3$ billion \\
(50\% chance) & ($0.33$ billion & ($1$ billion & ($3.3$ billion \\
& below BPF) & below BPF) & above BPF) \\
\hline
\end{tabular}
\end{table}

The variations from the expected values cause the actual compensation to deviate from the best possible fit between compensation and actual value. For example, in the upper left box, the claims and the firm both turn out to be worth \$1\ billion. Use of expected values gives claimants two-thirds of the firm, or \$0.67\ billion since the firm in fact is worth \$1\ billion. If the actual values of the claims and the firm had been foreseen at the time of reorganization, the award would have

\textit{nonbankrupt defendants. Tort policy, usually unconcerned with allocations from a limited fund, would provide a lump-sum payment from the nonbankrupt defendants. When faced with the problem of allocating a limited fund, bankruptcy and tort policy might seek equality among tort creditors and pay in a variable annuity. Though the methods are inconsistent, it seems that both could coexist. I leave to those interested in tort policy the question of whether joint liability should result in the nonbankrupt defendants paying the discharged portion of the bankrupt defendant’s debt to tort claimants.}

\textsuperscript{80} The over/under problem as it relates to contract creditors is dealt with infra notes 123–31 and accompanying text.

\textsuperscript{81} A small risk of this occurrence would lead to awarding most of the firm to the victims and would present no significant difficulties at least of undercompensation of the victims.

\textsuperscript{82} The following chart illustrates the potential variation, viewed in retrospect, of actual value received by claimants from an award of two-thirds of the firm’s stock, based on an expected claims value of \$2\ billion and an expected firm value of \$3\ billion, when aggregate claims’ value and firm value are uncertain. The best possible fit occurs when value received equals actual claims’ value. The boxed number is the value actually received in retrospect by the tort claimants’ fund.
1. Conventional Bankruptcy Solutions to the Disparity Problem. — While ordinary bankruptcy mechanisms afford some means for reducing disparity of outcome, their use in a tort reorganization could not eliminate the disparity problem. For example, consider the common use of debt in bankruptcy, which reduces distributional disparities caused by an uncertain future firm value. On the numbers in the above example, claimants could be promised the minimal firm value ($1 billion) in debt and receive $1 billion of the firm’s equity, which in this case is fifty percent. The expected value of their compensation would be $2 billion, which of course equals the expected value of their claims. In contrast to all-equity compensation, however, there is a good possibility of a perfect fit between compensated claims value and firm value, and the range of error would be reduced.

This possibility has partially offsetting defects, however, and can never be a complete solution. The obvious defect is that the debt burden may recreate some of the very problems we are attempting to avoid. That is, if the one-in-three chance of a low firm value occurs, the firm owes as much to the tort claimants in debt as it is worth. The firm then in some instances would be subject to control battles, the potential of asset and cash diversion, high-risk strategies, blocked access to financial markets, and missed investment oppor-

given all of the $1 billion of firm value in compensation for the $1 billion in claims. Claimants thus receive $0.33 billion less than the best possible fit in hindsight.

Notice that in no case does an award based on expected value “properly” compensate the claimants, viewed in hindsight. There is a 50% chance of undercompensation of as much as $1 billion. There is a 50% chance of overcompensation from $0.3 billion up to $2.3 billion.

Even if the stock awarded to the tort claimants could be quickly diversified or exchanged for equivalent value that is more certain to produce about the same expected value—treasury bonds, for example—an uncertain level of future tort claims will create over/under disparities.

83. The expected value of $2 billion is derived as follows.

<table>
<thead>
<tr>
<th>Actual Firm Value (33% chance each)</th>
<th>Actual Value of Debt</th>
<th>Actual Value of 50% Equity</th>
<th>Expected Value of Compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 billion</td>
<td>$1 billion</td>
<td>—</td>
<td>$0.33 billion</td>
</tr>
<tr>
<td>$3 billion</td>
<td>$1 billion</td>
<td>$2 billion</td>
<td>$0.67 billion</td>
</tr>
<tr>
<td>$5 billion</td>
<td>$1 billion</td>
<td></td>
<td>$1 billion</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>$2 billion</td>
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</table>

More realistically, the expected value will be a little less than $2 billion; in the one-out-of-three chance that firm value is the same as claims value, the claimants will have difficulty realizing the full $1 billion.

84. The following chart demonstrates the reduced range of error, viewed in retrospect, in value received by claimants from an award of $1 billion in debt and 50% of the firm’s stock. Again, the best possible fit occurs when value received in retrospect equals actual claims value. For example, when actual firm value and actual claims’ value are both $1 billion, the claimants receive $1 billion.
tunities. Reducing the debt level avoids this result, but increases the chance of a disparate value outcome.

Another "solution" would be simply to ignore the disparate outcome problem in tort-based reorganizations, since bankruptcy institutions regularly reduce uncertain values to average, expected values. Firm value is a highly uncertain educated guess that averages probabilistic outcomes. Under- and over-compensation occur often, viewed in retrospect. Disparity is the price paid for reorganization and putting the firm on a sounder financial footing.

Ignoring the problem may be acceptable in financial reorganizations, but it seems unsatisfactory in tort reorganizations. First, tort reorganizations involve two levels of uncertainty—in firm value and aggregate claims value—that on an a priori basis are perhaps more likely to correlate with one another and thereby exacerbate outcome disparities than they are to offset one another and thereby reduce those disparities. There is a good chance that the disparity will be greater in tort reorganizations.

Second, and I believe more to the point, the norm of accurate compensation is much more significant in tort reorganizations than in financial reorganizations; indeed, it may be central. In financial reorganizations, the actors—banks, insurance companies, the public shareholders—can bear the risk of a disparate outcome. They have either assumed that risk of miscompensation or can be viewed as having assumed it, and they often can diversify their holdings to offset its impact. None of this can be said about the individual tort claimant. He is far less able to bear such a risk. He cannot easily avoid the risk.

<table>
<thead>
<tr>
<th>Actual Claims Value</th>
<th>$1 billion</th>
<th>$3 billion</th>
<th>$5 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 billion</td>
<td>$1 billion</td>
<td>$2 billion</td>
<td>$3 billion</td>
</tr>
<tr>
<td>(33% chance)</td>
<td>(equals best possible fit) above BPF</td>
<td>(equals BPF) under BPF</td>
<td></td>
</tr>
<tr>
<td>$3 billion</td>
<td>$1 billion</td>
<td>$2 billion</td>
<td>$3 billion</td>
</tr>
<tr>
<td>(50% chance)</td>
<td>(equals BPF)</td>
<td>(equals BPF) under BPF</td>
<td></td>
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Use of the debt/50% equity mechanism results in a 50% chance of a perfect fit between ultimate compensation and actual claims value. Moreover, in the instance in which the all-equity mechanism produced a $2.3 billion disparity, see the upper right box in the chart supra note 82, the debt-and-stock solution reduces the gap to $2 billion. Nevertheless, there is a 50% chance of over- or under-compensating by $1 billion, and there is a 17% chance of overcompensating by $2 billion.

85. See Roe, supra note 20, at 549-58. Fixed debt when high in relation to firm value can create most of the operational risks that a high level of contingent tort claims creates. See supra notes 27-46 and accompanying text.

86. See V. Brudney & M. Chirelstein, supra note 29, at 77-78, 135.

87. If the product turns out to be safer than originally expected, not only will the actual value of claims drop from that expected at the time of reorganization, but the value of the firm should rise with greater product acceptance in the marketplace. Similarly, if the product proves to be more dangerous than originally thought, claims value will rise and firm value will drop.
by marketing his claim, did not assume the risk, and usually cannot diversify. 88

Thus, neither utilizing a debt/equity mechanism nor simply overlooking the disparity problem offers a completely satisfactory answer in tort-based reorganizations. Moreover, both of these alternatives accommodate only the uncertainty of firm value in finance-based reorganizations. They could not reduce the disparate outcomes that result from an uncertain aggregate claims level. We seem to face a spectrum of imperfect choices. If we wait until the ultimate value of the claims becomes more certain, the firm and its beneficiaries risk incurring operational costs due to delay. But if we reorganize immediately to reduce the operational risk, the distribution must take place under conditions of uncertainty.

Attempting to strike a balance between the two extremes will initially reduce operational risks without incurring uncertainty costs. 89 But such a compromise will eventually involve both some of the benefits and some of the costs of each. In our hypothetical reorganization

88. See supra note 65 and accompanying text. The individual cannot successfully diversify when the usually unsaleable tort claim represents a large portion of his wealth.

89. An example based on the hypothetical reorganization discussed supra note 82 and text following note 81 will illustrate this point. First, assume again that firm value will be $1 billion, $3 billion or $5 billion, and claims liability will be either $1 billion or $3 billion. If no reorganization takes place and the firm remains fully liable on the tort claims, what would be the residual value of the firm's stock under each possible combination of firm and claims values?

### Actual Value of Firm

<table>
<thead>
<tr>
<th>Actual Claims Value</th>
<th>$1 billion (33% chance)</th>
<th>$3 billion (33% chance)</th>
<th>$5 billion (33% chance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 billion (50% chance)</td>
<td>-</td>
<td>$2 billion</td>
<td>$4 billion</td>
</tr>
<tr>
<td>$3 billion (50% chance)</td>
<td>$2 billion</td>
<td>-</td>
<td>$2 billion</td>
</tr>
</tbody>
</table>

The expected value of the stock is $1.33 billion. The shaded area, where claims equal or exceed firm value, represents the zone of assured financial danger.

Second, assume now that in a reorganization $1 billion in stock is given to the claims pool trustee, who then sells the stock to diversify the claims fund. The first $1 billion in claims will be paid from the fund, with the firm remaining liable for any excess. What is the residual value of all of the stock after the discharge of the first $1 billion of liability?

### Actual Value of Firm

<table>
<thead>
<tr>
<th>Actual Residual Claims Value</th>
<th>$1 billion (33% chance)</th>
<th>$3 billion (33% chance)</th>
<th>$5 billion (33% chance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0- (50% chance)</td>
<td>$1 billion</td>
<td>$3 billion</td>
<td>$5 billion</td>
</tr>
<tr>
<td>$2 billion (50% chance)</td>
<td>$1 billion</td>
<td>$3 billion</td>
<td>-</td>
</tr>
</tbody>
</table>
example, a compromise approach might create a claims pool with enough of
the firm's stock to have an expected value of $1 billion, the minimum compensa-
tion due. The aggregate claims level, however, could reach $3 billion, an
amount substantially exceeding even the maximum value of the claims pool.
The firm would pay these excess claims when their value became certain.

This compromise would continue to subject the firm to some of the risks
that arise when a substantial cloud of unresolved claims hangs over the firm.
To reduce the operational risk further would require an increase in the present
turnover of stock to the claims pool. But increasing the present turnover in
order to reduce the operational risks would simultaneously increase the proba-
bility of an unnecessarily heavy shift of value from the old stockholders to the
tort claimants.

Thus, a repackaging of claims in an attempt to reduce both this aspect of
the over/under problem, and the level of contingent liability, requires a choice
between some operational risk and some disparity in outcome. The two costs
initially can be reduced simultaneously, but only in part. At some point, less
of the one means more of the other. Our previous bankruptcy experience
affords no complete way around this problem.

2. Insurance and the Disparity Problem. — The reorganization institu-
tions, however, may be able to turn to the insurance market for third parties

The expected value of the firm's stock is $2.17 billion. The shaded area represents a reduced zone
of financial danger. Tort claims are reduced from 56% of expected firm value (without reorganiza-
tion) to 27% of residual expected firm value (after an early reorganization gave them $1 billion
in value).

90. See supra text following note 81 and notes 82 & 84.

91. The minimum claims value is $1 billion. See supra note 82. The $1 billion should be
thought of as either a discharge of 50% of the $2 billion expected claims value or a discharge of
the first $1 billion in claims with liability in full for the excess. It should not be both a discharge of
the first $1 billion and of only 50% of any excess. The latter would provide tort claimants $1.5
billion instead of the $2 billion provided in a complete early reorganization. See note 82 and
accompanying text.

92. The claimants would have to be given about 46% of the firm's stock in order to receive
$1 billion in expected value. This result is not intuitively obvious; it depends on a changed net firm
value — operational value minus a changed level of tort liability — and a change in the impact of
the firm's limited liability. The firm's operational value remains the same but is now subject to a
lower residual liability. The firm, however, pays proportionately less of its total liability through
the two-step process discussed in text, than in an early reorganization based on expected values,
I.e., $1.83 billion instead of $2 billion.

The second of the two charts set forth supra note 89 helps explain this result. If $1 billion in
stock is given to the claims pool trustee, who then sells it to diversify the fund, the residual,
expected value of all of the stock after the discharge of $1 billion in liability is $2.17 billion. In
order to be sure that the tort claimants receive $1 billion, they must be given about 46% of the
firm's common stock ($1 billion + $2.17 billion).

If the claims pool trustee did not diversify the fund but instead continued to take the risks of
disparate firm value, the minimum compensation formula would be more complex.

93. Furthermore, as already noted, even a minimal discharge of tort liability will require a
turnover of a large portion of the firm's stock to the tort claimants. The claimants in our
hypothetical example must receive about 46% of the reorganized firm's stock in order to be
assured of receiving $1 billion in value. See supra note 92. Thus, the minimal-discharge reorgani-
ization would involve the emergence of a new control block, making even this kind of reorganiza-
to bear the risk of disparate outcomes, thereby both offering more complete assurance of proper compensation and allowing an early reorganization. In our hypothetical example, a portion of the $2 billion of compensation to tort claimants could be used to purchase an insurance policy to pay the victims. Claims have been posited to be worth at least $1 billion and there is a fifty-percent chance that they will be worth $3 billion. The trustee would retain $1 billion in value, the minimum needed to pay claims, and use the other $1 billion as an insurance premium. If insurers were to demand a small risk premium, a total premium of $1 billion would purchase nearly $2 billion in insurance. Such a purchase would assure almost complete compensation to all tort claimants.  

The trustee would first pay claims out of the $1 billion in assets retained in the claims pool. Those claims would be paid nearly in full, since the trustee would know that, with about $2 billion in insurance, up to about $3 billion—the maximum claims value—is available. If the value of the claims was to exceed the expected $1 billion minimum, the trustee would then turn to the insurer to pay the excess. The practicality of an insurance-based approach will depend on, first, the nature of the risk to be transferred and its effect on risk premium size; second, the size of the risk to be transferred and its effect on risk premium size; third, the absolute size of the total premium demanded for multi-billion-dollar risks; fourth, the availability of retroactive insurance generally; and fifth, the need for individual insurance for each contingent tort claimant.

a. Risk Premium Due to Nature of Risk. — Given the current primitive state of epidemiological prediction, the damage to be caused by a latent mass tort is highly uncertain. This unpredictability could cause an insurer to demand a significant risk premium. We have seen that if the risk premium is small, a $1 billion premium payment in our example would guarantee a nearly one-hundred percent compensation level. If insurers demand a large risk premium, however, a $1 billion payment would ensure no more than, say, an eighty percent compensation level. The desirability of purchasing insurance

| tion a messy affair. Yet it will not eliminate entirely the risk of operational debility arising from the unresolved residual tort claims. |
| 94. One billion dollars is the expected value that results from a 50% chance of a $2 billion payout and a 50% chance of no payout—probabilities that follow from equally possible claims values of $1 billion or $3 billion. Thus, a $1 billion premium should purchase nearly $2 billion of insurance, assuming a small risk premium. Together with the $1 billion remaining in the claims pool, about $3 billion would be available to pay claims. |
| 95. An insurance-based solution would help tie up one other loose end: One must decide what to do with the excess if it turns out that the claimants' pool has been overcompensated. The excess could be distributed among the claimants, given to charity—perhaps one dealing with the claimants' underlying disease—or returned to the operating firm. Using the potential excess as an insurance premium might be considered the most legitimate use; at the time of the premium payment, it would not be known that there was in fact an excess. |
| 96. I refer here to the size of the premium in comparison with the value of the risk assumed. See infra text accompanying note 107. |
| 97. Since there is a 50% chance that claims will total only $1 billion, there is a 50% chance that the uninsured $2 billion claims pool will fully compensate all claims. Similarly, since there is a 50% chance that claims will total $3 billion, there is a 50% chance that the $2 billion claims pool will undercompensate each claim by one-third. |
will depend on the size of the risk premium demanded, compared to the value to the tort victims of an assumption of that risk.98

b. Risk Premium Due to Size of Risk. — Whether the risk premium demanded is worth paying may depend in part on the size of the aggregate risk transferred. If the aggregate risk is within the range for which insurance markets work well, then, tautologically, the risk premium will be less than the cost of risk to the individual contingent tort claimants.99 The risk borne by the insurers, however, is not the same thing as the aggregation of the risks borne by the future tort claimants. Each contingent claimant bears the risk of, say, a $50,000 compensatory payment or a $100,000 payment. The insurers bear an aggregate risk that, if large enough, may impose other costs on them—bankruptcy, for example. These potential costs could lead them to demand a risk premium that the individual claimants would not find worthwhile to pay.100

The possibility that the market would not effectively insure risks as large as multi-billion-dollar mass tort risks appears quite real. That is, the market may require a risk premium that the trustee and contingent tort claimants would not find worthwhile to pay. The insurance market, for example, apparently could not completely insure the operators of nuclear power plants against a nuclear disaster.101 Moreover, some have supposed that the market could not provide insurance covering billion-dollar toxic torts.102

98. Insurers should be no worse at predicting tort risks than others involved in the risk-allocation process; they often would seem to be better able to bear the uncertainty that arises from the nature of the risk than the victims.

99. If the risks are too great for a single insurer to absorb, typically the single insurer will write the insurance and then syndicate portions of the risk to other insurers, called reinsurers for this purpose.

100. This relationship will be recognized as that of supply and demand. The trustee would want risk to be transferred from the individual tort victims and would be willing to pay something for that transfer. Insurance companies would be concerned with the level of aggregate risk whereas individual claimants would not. The risk aversion of the individuals in the pool would not be likely to increase as more individuals were added to the pool, i.e., as the aggregate claims rose. But as the aggregate claims rose, the consequences of the risks to the insurance industry would become more costly. This relationship can be graphed with supply and demand curves modified only slightly from the standard versions:

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Percentage
Demanded
Risk Premium
(for individuals,
percentage of
expected value
of claim
willingly
paid to
others to
bear risk)

Market capacity to bear risk

Individual willingness to pay
others to assume risk

Billions of Dollars of Claims

The empirical question is whether I* is more or less than the aggregate risk to be insured.


102. Schmalz, supra note 2, at 190 (suggesting saturation of the private insurance market at below $1 billion for hypothetical fund for hazardous waste disposal); Lewin, Business and the
The insurance market, however, does bear some aggregate risks in the multi-billion-dollar range. The insurance industry has paid aggregate claims of nearly $1 billion resulting from damage caused by a single hurricane. The total value of the insured risk—property together with associated coverages—presumably was even higher. Moreover, insurance companies' aggregate surplus, an amount that can be at risk, was estimated a few years ago to be $50 billion. Although that surplus is now devoted to risks other than the mass tort risks under discussion, one could guess that the size of the surplus indicates that mass tort risk coverage might be within the reach of the marketplace. Whether the sheer size of the risk without more would preclude an insurer or group of insurers from providing coverage for excess claims presents an empirical question that at this date remains open.

c. Absolute Size of Total Premium. — The size of the risk aside, the absolute size of the insurance premium could be too large for any firm to consider seriously. Neither a nuclear utility facing the possibility of a nuclear disaster nor a chemical company facing the possibility of a massive toxic tort, for example, can afford billion-dollar insurance premiums. They are not prepared to buy insurance that would bankrupt the firm. But the question here is how to allocate the value of a firm that is already bankrupt. The

Law: Insurance For Past Risks, N.Y. Times, Apr. 6, 1982, at D2, col. 1 (no retroactive insurance policies for asbestos industry as of April 1982). The fabled Lloyd's of London has an aggregate of $6 billion at risk, see Hodgson, Restoring the Lloyd's of London Mystique, N.Y. Times, Mar. 1, 1984, § 6 (Magazine), at 48, 52, 56; such an amount might be insufficient to absorb multi-billion mass tort risks such as those involved in the asbestos bankruptcies. But cf. Manville Report, supra note 58, at 1,614 (efforts by asbestos claimants' counsel to negotiate such a claims-made insurance plan with Manville Corporation's preexisting insurance carriers, which are litigating the question whether their prior insurance covers Manville's ongoing asbestos claims).


105. If more than one insurer consortium is available, then the trustee might have the opportunity to take bids. The insurer group willing to pay the highest percentage of asserted claims for the proffered premium payment would get the business. If an open-ended risk proves to be too difficult to market, the trustee could take bids based on a stated maximum coverage, i.e., the percentage of each claim the insurer would be willing to pay up to, for example, $5 billion in total claims. If the trustee wishes to maximize the amount of coverage, the trustee could ask for bids to pay, say, 80% of all properly asserted claims up to the bid amount of claims coverage, with the contract going to the consortium that is willing to provide the highest coverage.

One difficulty with a scheme of competitive bidding is that the bids may be based partly on the insurers' ability to resist claims cheaply and effectively, regardless of their actual merits. The trustee, however, wants to make the best possible allocation of the bankruptcy proceeds. Resolving this problem may require an objective schedule of damages and liability to be constructed.

The risk to be transferred could be small enough that it falls within the range for which the insurance market works well, yet large enough that a reinsurance consortium would have to involve nearly every participant in the market. The trustee and the insurance industry would then face one another as bilateral monopolists. Competitive bidding among insurers would be impossible; the insurance purchase would involve intensive negotiation that might fail.

106. Of course, the size of the firm and the risk need not necessarily reach the billion-dollar range; a relatively small firm might file for bankruptcy when faced with a comparatively modest contingent tort liability.
bankrupt firm cannot readily pay a $1 billion insurance premium in cash, but it can pay for the policy in the new stock that displaces the old ownership interests and claims on the firm.\(^\text{107}\) Or the pool trustee can market some or all of the claims pool’s $2 billion in stock and then purchase the insurance. In the setting of a mass tort bankruptcy, the payment of a billion-dollar premium is conceivable.

d. Retroactivity. — The insurance that would be purchased by the claims pool trustee would be retroactive; the events that underlie the liability insured against would have already occurred. Only the extent of damage and consequent liability remains unknown.\(^\text{108}\) Retroactive insurance would be neither a new creation nor unique to bankruptcy reorganizations involving mass tort claims. With increasing frequency,\(^\text{109}\) firms have purchased insurance after a disaster to insure against a widely variable, contingent aggregate liability.\(^\text{110}\)

e. Individualized Insurance Coverage. — One commentator has suggested that, in those reorganizations in which identifiable individuals have been exposed to risk but have not yet manifested injury, each individual might be allowed a claim in an amount sufficient to buy insurance against the possibility of eventual injury.\(^\text{111}\) The suggestion presents two problems that make it unlikely that individualized insurance will work well. First, the identity of contingent future claimants will often be unknown, indeed unknowable. Such claimants might be the future users of a product or their bystanders.

Second, even in those few instances in which the individuals at risk are presently identifiable, the transaction costs involved will often render individualized insurance impractical.\(^\text{112}\) Particularization of the likely risk of damage

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\(^{107}\) Alternatively, the new stock could be sold under the bankruptcy court’s guidance and the cash proceeds used to buy the insurance. See supra note 63.

\(^{108}\) The legal standards that will be applied in future lawsuits to these past actions, of course, also remain unknown. See Epstein, Manville: The Bankruptcy of Product Liability Law, Regulation, Sept./Oct. 1982, at 14.


\(^{110}\) The most prominent example is MGM’s purchase of additional liability insurance a few days after a 1981 hotel fire killed 84 guests at its Las Vegas hotel/casino. Lancaster, MGM Grand to Cover Hotel Fire Claims with $170 Million Retroactive Insurance, Wall St. J., Feb. 11, 1981, at 4, col. 1. With $30 million of precatastrophe insurance in place, MGM paid a premium approximating $40 million for $170 million of additional coverage. Wall St. J., Mar. 15, 1983, at 16, col. 2. Some differences do exist between insurance for the MGM fire and for a mass tort bankruptcy; however, the retroactive insurance in the MGM fire probably did not require as substantial a risk premium as would insurance in a toxic-tort bankruptcy. The number of MGM fire victims was readily determined, unlike in a toxic tort disaster. The insurance company had experience with the type of claims involved. In a toxic tort case, in contrast, the insurer would be undertaking the unknown risks of increased incidence and severity of disease. Finally, the apparent private advantage to MGM of the differential tax treatment of the insurance premium—deducted early by MGM, but taken into income later by the insurers—may not be relevant to the purchase of the insurance discussed in the text.

\(^{111}\) See Note, Procedures, supra note 55, at 172.

\(^{112}\) See G. Calabresi, supra note 64, at 136.
to an individual usually will be much more difficult and costly than generalization of the likely risk to an exposed population. If a population of 100,000 has been exposed to a carcinogen that will lead to 1000 cases of cancer, individualizing the insurance coverage requires 100,000 transactions. Individuals in the exposed group are not likely to be well-informed when shopping among insurers; moreover, only 1000 in the group will actually need the insurance payments. In retrospect the efforts of nearly everyone in the exposed population will be unnecessary as well as comparatively expensive and, one suspects, inaccurate. Pooling permits the reduction of the transactions involved to 1000 individuals, a single insurer, and the court. If the market is to provide the insurance at all, it would more likely do so through a pool, rather than through individualization.

3. The "Purgatory" Alternative to Early Reorganization. — Aspects of the problems of uncertainty and disparity could sometimes be controlled by placing the firm in bankruptcy, freezing distributions and enabling new financing, but without pursuing an early distribution of financial value. This alternative might be considered when the range of uncertainty is enormous, the firm is likely to be able to satisfy the potential liability, and an early reorganization may easily misdistribute value.

Posit a chemical firm worth $2 billion that releases a carcinogen from one of its plants, exposing the population in the surrounding environs to the risk of serious disease. A full cure might be developed before the incidence of disease becomes significant. If the cure is developed, there will be no damages; but if the cure fails, the aggregate damages will be $2 billion. An early reorganization based on expected values would award half the firm to the contingent claimants. The trustee for these claimants might then seek and purchase $2 billion of insurance. If the trustee does so and the disease were

113. The risk may thereafter be spread to a number of insurers through reinsurance. See supra note 99.

114. The problem of transaction costs is sufficient to doom individualized mass tort insurance. In addition, individuals often disregard low-probability, catastrophic risks. The individual may underrate or simply refuse to evaluate the risks—"It won't happen to me"—may gamble on society picking up some of the costs—for example, the costs of medical care in a public or veterans' hospital—or may see current family needs as more important than the uncertain, future risk of disease. Cf. Rea, supra note 77, at 132 (suggesting similar reasons for using periodic payments in tort damage awards). There is empirical evidence, for example, that tort victims facing a period of long-term disability nevertheless will not take steps to assure themselves a stable income during that time if they receive their compensation in a lump-sum. See James, Damages in Accident Cases, 41 Corn. L.Q. 582, 585-86 (1956). Potential victims receiving lump-sum compensation would seem even more likely not to take the appropriate precautions. See generally Friedman & Savage, The Utility Analysis of Choices Involving Risk, 56 J. Pol. Econ. 279 (1948). Accordingly, a collective decision that the potential victims insure may be socially preferable. Since individuals are unlikely to obtain insurance voluntarily, either individual insurance would have to be mandated or claims pool insurance would have to be instituted.

115. See supra notes 94-114 and accompanying text.
subsequently cured, then the firm's stockholders would have lost half of their stock's value, although in retrospect the firm caused no damage.  

Thus early reorganization would entail a series of complex transactions. Yet if a cure is developed, these transactions in retrospect would have mistakenly redistributed firm value, solely to avoid the risk of operational collapse. A hybrid, "purgatory" approach to the disparity problem may resolve the dilemma. If the principal risk facing a firm with significant assets and competent management is that it could not operate well without early reorganization, it could be placed in bankruptcy in order to hold its assets and management together, and to allow the financing of new projects through the use of priority certificates. Dividends would not be paid, and creditors' claims generally would be held in abeyance or paid only in part. No complete redistribution of the firm's value would take place until the uncertainty about the claims value was resolved. If no cure were found by the time actual tort claims were overwhelming the firm, the firm would be turned over to the claimants' representative. If a cure were found, the firm would be returned to the stockholders.

The "purgatory" alternative is an adequate solution in some instances of pervasive uncertainty, but it is not clear that it can ever be a complete answer. The firm may continue to be subject to some of the operational risks that we have seen are created by delay. Moreover, if the maximum potential liability substantially exceeds firm value, it is not clear what the proper compensatory solution is. For example, if the maximum aggregate damages in the example at hand were $4 billion instead of $2 billion, an early reorganization could allow the claims pool trustee to purchase full insurance coverage, using as a premium the $2 billion that current firm value would provide. If reorganization were delayed until the amount of damages became clear, the tort claimants would receive only 50% of their claims.

Finally, and most importantly, the mass tort case must be one for which a delayed redistribution of value is appropriate. If the minimum aggregate claims value represents a large percentage of firm value, there is no point in delay. The basis for delay is pervasive distributional uncertainty, at least so

116. To be sure, the stockholders are assured of receiving $1 billion in value by early reorganization when delay could oust them entirely.

117. Furthermore, an early reorganization would eliminate the shareholders' incentive to find a cure, without ensuring that the claimants would quickly organize continued efforts to find the cure.


119. Id. § 364. Financiers sometimes would be willing to lend the firm capital if they were given priority over preexisting creditors on their claims.

120. The variable annuity procedure discussed supra notes 66-79 and accompanying text could be begun for maturing tort claimants and, perhaps, preexisting trade creditors.

121. See supra notes 27-46 and accompanying text. Some distributional uncertainties could be resolved quickly without waiting for elimination of all uncertainty. In the ongoing asbestos reorganizations, for example, the liability of the bankrupt firm's insurance carriers is an open question, resolution of which would substantially affect the size of the funds available for
long as delay would not undermine the firm’s ability to compensate. If that uncertainty is not present, at least the minimally certain claims value ought to be redistributed in the early reorganization.122

— When it is very uncertain whether aggregate claims will exceed firm value, the bankruptcy solutions become more complex, but not impractical. The crucial problem is that in retrospect an early reorganization will turn out to have seriously misdistributed value. The risk of misdistribution cannot be eliminated, but it can be reduced in several ways, including conventional bankruptcy use of debt and stock, partial reorganization affecting only the minimally certain claims, full reorganization with pooled insurance, or, in limited circumstances, a freeze on distributions while the firm operated in bankruptcy.

compensating tort claimants. See generally Note, Adjudicating Asbestos Insurance Liability: Alternatives to Contract Analysis, 97 Harv. L. Rev. 739 (1984). If the jurisdictional authority of the bankruptcy courts were clear, see Northern Pipeline Construction Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982), this would be the type of question ripe for resolution prior to a distribution of value.

122. The purgatory alternative’s principal difficulty is that some will have an interest in pursuing the alternative, some will have an interest in opposing it, and under conditions of uncertainty the court will not find it easy to decide quickly what to do. Deadlock, litigation and consequent delay would be the likely result.

“Purgatory” will be recognized as similar to an ordinary receivership: property is brought under court protection, the formal owners cannot control its disposition, and after a period of judicial administration the property is distributed to creditors, with the remainder if any returned to the owners. Like receivership, the “purgatory” alternative would keep the firm insulated from the corporate takeover market, and thus could reduce managerial incentives to operate the firm efficiently.

“Purgatory” differs in several respects, however. First, courts do not relish the task of administering property in receivership. Receivership is simply viewed as an ancillary evil needed to preserve the estate while ongoing controversies are settled. 3 R. Clark, A Treatise on the Law and Practice of Receivers 1270-71, 1297 (3d ed. 1959) (“a petition cannot be filed asking for the appointment of a receiver as the final relief in the case, because courts are not created primarily to administer property or to carry on business, but to adjudicate rights”). The “purgatory” alternative contemplates not a current legal controversy, but pervasive value uncertainties that require delay in distribution. Second, receiverships usually are not particularly long. Id. at 1270-71. (“Seven years is an unusual time to permit property to remain in the hands of receivers.”). But for mass torts with latent effects, uncertainty might regularly remain unresolved for a decade or more. Third, receivership has been viewed as creditors’ remedy limited to the prevention of asset diversions. Id. at 1339-40. Even absent diversions, the “purgatory” alternative would be useful in facilitating the best operation of the firm—through financing new projects with priority certificates, for example—until the distributional uncertainty were cleared up.

Elements of this accommodation of uncertainty of value can be seen in some railroad reorganizations. In the reorganization of the New Haven and Hartford Railroad, the railroad’s assets were transferred to Penn Central prior to a final valuation of the New Haven. See New Haven Inclusion Cases, 399 U.S. 392, 399, 408-16 (1969); in re Pennsylvania R.R., 327 l.C.C. 475, 527 (1966).
D. Other Problems in Implementation

At least two other issues will have to be resolved in implementing a claims-pooling approach to mass tort reorganizations—uncertainty in the value of tort claims in relation to other claims, and practical problems of pool management.

1. Uncertainty of Aggregate Tort Claims Value in Relation to Other Claims. — Under the current statutory framework, unsecured contract creditors generally share in a bankruptcy distribution on a pro rata basis with tort claimants.\(^\text{123}\) Once again, given a wide range of uncertainty concerning aggregate claims value, an early distribution of firm value could result in disparate compensation outcomes.\(^\text{124}\) Four considerations, however, could often render this theoretical possibility largely irrelevant in mass tort reorganizations. Moreover, even when this uncertainty is present, it may sometimes be possible to reorganize early to relieve operational pressures while leaving contingent claims unaffected, without seriously miscompensating contract creditors.

a. The Minimal Relevance of Uncertainty When Tort Liability is Relatively Large. — First, this level of uncertainty often may not be present to any significant degree in tort reorganizations. The aggregate level of tort claims may not vary widely, or there may be relatively few contract claimants. Moreover, the expected value of the tort claims may be large in relation to the unsecured contract claims, in which case the tort victims would never be significantly undercompensated. If, for example, the expected tort claimants are awarded ninety percent of the firm's value, based upon the expected value of their aggregate claims, they face a maximum undercompensation of ten percent should the aggregate claims level prove to be higher than expected. As long as the minimum value of tort claims is large in relation to contract claims, both the range of disparity based on actual outcome and the proportionate range of potential undercompensation of tort claimants would be reduced.\(^\text{125}\)

\(^{123}\) The Code prohibits unfair discrimination in the distribution of values; it permits discrimination only if the distributee class consents or its rights are unimpaired. Bankruptcy Code § 1129(a)(8), (b)(1). The legislative history, however, only provides examples of unfair discrimination among contract creditors when there is deviation from a pro rata distributional framework. H.R. Rep. No. 595, 95th Cong., 1st Sess. 416–17 (1977). Presumably the bankruptcy notion of fairness therefore would not encompass nonconsensual overcompensation of tort claimants in comparison with contract claimants, but this is not clearly established doctrine.

\(^{124}\) The following example illustrates this problem of uncertainty. Assume a firm value of $2 billion, contract claims of $1 billion, and tort claims of either $1 billion or $5 billion, each equally likely. The tort claimants would be awarded 75% of the firm, since the expected aggregate tort claims value of $3 billion represents three-fourths of the total claims on the enterprise at the time of reorganization. The actual outcome would have given the tort claimants either 50% ($1 billion in tort claims) or 83% ($5 billion in tort claims) of the firm. Thus, the tort claimants would have been either overcompensated 25% of the firm's value or undercompensated 8% of the firm's value.

\(^{125}\) For example, using the figures given supra note 124, assume that the tort claims will total $3 billion or $7 billion, each equally likely. The variance of uncertainty ($4 billion) remains
Second, focusing for the moment only on the goal of properly compensating tort victims, we must recognize that the firm's financial structure is a dynamic one. Postponing reorganization would not preserve the status quo for a later decision under a clearer, more certain light. In the interim, the contract claims would come due and be paid, at least in part, usually leaving less for future tort claims. In short, delaying reorganization effectively makes some contract claimants' rights of payment superior to those of the contingent tort claimants. The level of uncertainty concerning the valuation of tort claims, moreover, may not have diminished at all during the delay.

Third, we must consider whether contract claimants should be viewed as having agreed to bear the risk of under- and over-compensation in a tort reorganization. To some extent, of course, an affirmative answer would merely restate a conclusion that they ought to bear the risks. As previously discussed, however, the relative risk-bearing capacity of contract and tort claimants may be relevant in considering the question of risk allocation. The risk of inaccurate compensation of contract claims due to uncertain expectations about aggregate claims value is qualitatively identical to the risk that contract creditors take under ordinary financial reorganizations, in which firm value, and thus the investment value of contract claims, are uncertain.

the same, but the range of claims levels has been raised. The maximum over- and undercompensation levels then fall: the tort claimants would be awarded 83% of the firm, since the expected aggregate tort claims value of $5 billion represents five-sixths of the total claims on the firm at the time of reorganization. The actual outcome would have given the tort claimants either 75% ($3 billion in claims) or 87% ($7 billion in claims) of the firm. Thus, the tort claimants would have been either overcompensated 8% of the firm's value or undercompensated 4% of the firm's value. Contract claimants would be subjected to the converse risks, which would be large in proportion to their actual compensation.

126. The problem could be avoided by resorting to a peculiar sort of reorganization, in which a stay against creditor payments, see Bankruptcy Code § 365, would be invoked but years would go by without any effort to reorganize. When the uncertainty is expected to be resolved quickly, it might be possible to use this "purgatory" alternative to early reorganization. See supra notes 114-22 and accompanying text. Bankruptcy institutions would prevent diversions of value, but would not redistribute the firm's financial value until uncertainties were reduced. Or the partial distribution approach discussed supra notes 89-93 and accompanying text could be employed. The minimally certain claims value could be distributed, leaving the resolution of residual uncertainties to the future. If the residual claims were small enough, the firm could leave bankruptcy after making the minimum redistribution.

127. See supra text accompanying notes 63-65.

128. For example, assume that senior creditors are due $5 million and junior creditors are also due $5 million. The firm is valued at $10 million, based on equal chances of being worth over time $5 million, $10 million, or $15 million. A $10 million value gives seniors $5 million of common stock, and juniors $5 million. Old common stock is eliminated. Yet if the firm turns out to be worth only $5 million, the juniors would have been overcompensated and the seniors undercompensated, if both were compensated in common stock. In some instances, use of debt could alleviate the risk of disparate outcomes. See, e.g., supra notes 82-85 and accompanying text. But neither the policy of debtor rehabilitation nor Bankruptcy Code § 1129(a)(11) would permit so much debt to be incurred that firm viability is threatened.
Since contract creditors have taken these risks in financial reorganizations, it would not strain bankruptcy policy to allocate similar risks to them in tort reorganizations as well. 129

Finally, in determining whether some miscompensation of tort victims is acceptable, we must balance the risks of firm mismanagement inherent in postponing reorganization until the uncertainties are clarified against the risks of faulty compensation. Some might even argue that the desirability of efficient firm operation itself may justify a compensation scheme that systematically undercompensates tort claimants. But such an argument is unnecessary here. Since the tort victims become owners of the firm—albeit perhaps only temporarily—when their claims in the aggregate are large in relation to firm value, they have an interest in seeing it operated in an optimal manner. Efficiency in firm operation maximizes the value of their ownership interest; the stock of a well-operated enterprise should sell for more than the stock of a financially distressed enterprise. The tort claimants therefore should expect more compensation on the average from an early resolution in bankruptcy, notwithstanding the possibility of disparate compensation outcomes. 120

b. Partial Reorganization and Uncertainty. — When the level of tort claims is significant, but not an extraordinarily large portion of firm value, it nevertheless may be crippling when aggregated with a significant level of contract claims. The two types of claims jointly induce financial stress. When this is so, the benefits of debtor rehabilitation can be obtained in an early

129. Although this Article uses a general distributional framework of creditor equality, see supra notes 47-50 and accompanying text, several aspects of its analysis will favor tort creditors over contract creditors and shareholders. For example, I suggest that an early reorganization is needed to effectuate debtor rehabilitation when tort claims have a high probabilistic value in relation to firm value, but that no reorganization is warranted when that expected value is relatively low. This analysis would allow the tort claimants to seize the firm when the probabilistic value of their claims is high, even though their value might later turn out to be lower than originally expected. Yet when the expected value is low initially, their claims need not be frozen into that low value. Heads the tort claimants win; tails the system waits to see what the ultimate value of their claims is. Tort claimants in the aggregate would tend to be compensated more than their aggregate pro rata share.

This framework seems diametrically related to the second-look doctrine, which would revalue a firm years after bankruptcy and give excluded interests, such as stockholders, a new interest if the firm were more valuable than expected. The doctrine has been decisively discredited as a basis for implementation of contract-based absolute priority and creditor equality. See Brudney, The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule, 48 Am. Bankr. L.J. 305, 331 (1974). The basis for a tort-based "second look" is intertwined with the norm of debtor rehabilitation: early reorganization is necessary only when the aggregate probabilistic level of tort claims is large. On the other hand, enhanced treatment of tort claimants in bankruptcy, if significant, could affect prebankruptcy investment markets if it were anticipated. One would then have to resolve a conflict between policies of fostering investment markets and of compensating tort claimants.

130. But see supra notes 87-88 and accompanying text (norm of accurate compensation may be more significant in tort reorganizations than norm of increasing average compensation); infra notes 187-204 and accompanying text (suggesting possibility that early resolution may lower tort claimants’ compensation if there are systematic information disparities).
reorganization without affecting the contingent tort claims; that is, without compensating them or discharging the firm’s future liability on them. For example, posit a $2 billion firm with a highly uncertain level of tort claims totalling $500 million in expected value, and $1 billion in contract claims. A reorganization in which contract claimants took $1 billion of the new common stock would substantially alleviate the financial stress on the firm.

But when the firm’s assets are less than its aggregate tort and contract liabilities, such a result could give tort claimants something better than their pro rata share, because giving stock to contract claimants effectively subordinates them to tort claimants. For example, assume that the $2 billion firm with $500 million in expected tort claims now faces $2 billion in contract claims. An early reorganization that left tort claims unaffected could not give the contract creditors more than $1.5 billion in expected value (expected firm value of $2 billion minus expected tort claims value of $500 million). The contract claims would be scaled-down to 75% of their face value, while the tort claims would be paid in full. But the amount taken away from the contract claimants will not be great, since by hypothesis the tort claims are not large in relation to firm value. In the example just used, contract creditors were 80% of the firm’s creditors, and received 75% of the face value of their claims, a reduction of only 5%.131

c. Aggregate Contingent Tort Claims in Relation to Other Claims: Summary. — Uncertainty in the distributional result between tort and contract claimants presents difficult questions. But when the tort disaster is so severe that the tort claims dwarf the contract claims, the distributional uncertainties will not especially miscompensate either set of claimants. In some instances, a partial reorganization that gives value to the contract claimants in the form of stock in the reorganized enterprise, but that leaves the firm undischarged on its tort claims, may be satisfactory to the parties and to those attempting to rehabilitate the debtor firm worth preserving.

2. Practical Problems in Claims Pool Management. — Managing a stock pool for the tort claimants would present additional practical problems. First, control blocks could emerge and cause difficulty. That is, contract creditors presumably would not participate in the pool, but would receive their compensation directly. If they received a minority share of the firm as common stock, they would be minority shareholders to whom the claims pool trustee, as representative of the majority shareholders, would owe some fiduciary duties. Minority shareholders could also emerge as the trustee sold shares in the reorganized firm to diversify the claims fund. In either instance, the trustee might try to meet a need for additional compensation payments by forcing the reorganized firm—which the trustee would control—to make larger cash dividends at a time when the trustee thought that stock sales were not propri-


Presumably current noncontingent tort claimants, for whom there are no valuation uncertainties, would participate in the early reorganization.
tious.\textsuperscript{132} The firm, however, may have business opportunities that it could not pursue if it made such cash dividends. The trustee therefore might be forced to choose between the duties that majority stockholders owe to minority stockholders and the need to compensate claimants. Either choice could lead to litigation.\textsuperscript{132}

Second, the trustee would have to be given the incentive and authority to resist frivolous claims, since the bankrupt firm no longer would have that incentive once it has been discharged of all liability. Third, given the inability of unknown future claimants to control the fund manager, the court supervising the reorganization would have to ensure that the claims pool was being managed professionally. Finally, the tax status of the claims fund—whether as a nonprofit corporation, investment company, trust, or new entity entirely—would have to be resolved.

These problems hardly seem insurmountable; some, such as the control block problem, are simply variations on more widespread corporate problems. Certainly they can be mitigated by good management and, at least on the tax aspects of claims pooling, by legislation.

E. Accommodating Uncertainty: Summary

In \textit{In re UNR Industries},\textsuperscript{134} the first court to directly face the problem of tort-based bankruptcy lamented that little of practical value could be done in

\textsuperscript{132} The trustee might face this conflict if it appeared that the market was not accurately valuing the firm's stock or the value was accurate in light of publicly known information but the trustee had inside information indicating that an above-market value was warranted. In such circumstances the trustee would prefer to wait and sell the stock at a later date.

\textsuperscript{133} The control-block problem is not trivial. If the sale of a multi-billion dollar firm took several years to accomplish, the tort claimants would not readily have the benefits of a diversified claims pool.

The trustee probably will have access to better information about the enterprise's prospects than the general public. This informational advantage will make outsiders fearful that the trustee is not selling solely to diversify the pool's holdings but instead is selling because of adverse information concerning the firm's prospects. This information may not be readily available to the public, despite the disclosure requirements of the securities laws; while "hard" information must be disclosed, securities regulators have had much more difficulty ensuring the flow of accurate "soft," evaluative information. See H. Kripke, supra note 44, at 71-74. Thus in the absence of equal informational access, the outsiders may undervalue stock sold by the trustee even when the trustee has no adverse information. Cf. Scholes, The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices, 45 J. Bus. 179 (1972) (downward drift in price of stock at time of secondary sale is due to public speculation that insider seller has negative, undisclosed information about the firm). To eliminate this informational asymmetry, the outsider would have to make an independent, expensive investigation and evaluation of the firm. Hence the trustee might find it difficult to market the stock other than in large blocks. Since block-buyers are not necessarily available on short notice, the benefits of diversification would not be immediately available after reorganization. But this problem would merely delay delivery of the benefits of diversification to claimants; it is not itself worse for claimants than no reorganization at all.

an early reorganization, apparently because of the extraordinary uncertainties of future values. If by that the court meant that nothing could be done for unidentified claimants having claims of an uncertain aggregate value, we have seen that, on the contrary, mechanisms can be devised to telescope those claims into an early reorganization, with the risks of a misdistribution of value reduced or eliminated.

Claims can be pooled in a manner similar to that used by a pension fund. Furthermore, even when uncertainty about aggregate claims value is acute, a distributional framework still can be constructed. Epidemiological certainty is unnecessary; knowledge that the expected tort claims exceed the firm’s value, and that the value of contract claims is relatively small, is sufficient to justify turning over all or a large portion of the firm’s stock to the claims pool trustee. Yet the uncertainty of aggregate future claims value will create a risk of misdistribution among the tort claimants inter se. This difficulty can be accommodated by compensating the claimants on a basis similar to a variable annuity, to roughly equalize the compensation among victims. Tort claimants would be paid annually based on the ratio of expected aggregate claims value to the pool’s value.

The difficulty of predicting with certainty whether or not aggregate claims value will exceed firm value is also sometimes amenable to practical accommodation. First, the tort claimants can be given the minimum value of their claims via a pool of some of the firm’s stock, while firm liability is maintained for the excess. This approach unfortunately cannot always be a complete solution, since a potentially significant, albeit reduced, cloud of excess claims could continue to hang over the firm. After providing for the minimum level of compensation, the court must choose some combination of the undesirables: operational risk and potential misdistribution. But this hybrid reorganization would be satisfactory if it relieved enough of the operational pressures.

Second, the problem of misdistribution can be reduced through the insurance market. There is some reason to hope that the market could provide the desired insurance, although no effort to do so has yet been successful. Finally, in some limited circumstances the firm could be put under bankruptcy protection with a delay in distributing value until the uncertainties were resolved.

III. THE STATUTORY AND CONSTITUTIONAL BASIS FOR EARLY REORGANIZATION

To say that a pooling of mass contingent tort claims in an immediate reorganization would best implement the goals of debtor rehabilitation and equal treatment of creditors is not to say that the current Bankruptcy Code

135. Id. at 744, 746 (indicating that "[t]he Application raises various ... practical ... problems" but leaving such problems largely unspecified); see also In re Amatex Corp., No. 83-0011, slip op. at 2 (E.D. Pa. Nov. 7, 1983) (adopting OVR district court’s analysis), aff’g 30 Bankr. 309 (Bankr. E.D. Pa. 1983).

136. See supra notes 18-50 and accompanying text.
will permit such an approach. The first court to face this matter squarely concluded that the Code precluded such an early reorganization. Indeed, it suggested that the claims pooling approach may also clash with constitutional due process norms. The statutory construction offered by that court is unconvincing, however. Furthermore, an analysis of the economic relationships involved strongly suggests that due process notice doctrines should not bar a tort-based reorganization if the expected aggregate value of the tort claims exceeds the value of the firm. This Part examines these statutory and constitutional issues.

A. Early Reorganization and the Bankruptcy Code

Does the current statutory framework permit an early tort-based reorganization? The Code does not explicitly provide authority for compensating unidentified future claimants. The task of statutory construction must begin by noting who can take value in the reorganization. The Code permits only a "creditor" to bring a "claim" into a bankruptcy proceeding. The statute defines "claim" broadly to encompass unliquidated, unmatured and contingent rights to payment, but requires a "creditor" to have a claim that has already arisen. Whether contingent future tort claims—claims based on already-completed, past acts of the bankrupt firm—can be pooled and resolved in an early reorganization depends on whether they have already arisen within the meaning of the Code. Despite the potential adverse consequences


141. Bankruptcy Code § 101(9)(A) defines a creditor as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor."

142. The Code provides that the provisions of a confirmed plan bind "any creditor" of the debtor. Id. § 1141(a) (emphasis added). If the term "creditor" does not include future tort claimants, plan confirmation would not bind future tort claimants. See also id. § 1141(c) ("After confirmation of a plan, the property dealt with by the plan is free and clear of all claims . . . of creditors . . . ") (emphasis added). The Code also provides that "the confirmation of a plan . . . discharges the debtor from any debt that arose before the date of such confirmation." Id. § 1141(d)(1) (emphasis added). But cf. id. § 727(a)(1) (denying discharge to liquidating corporations).
of answering this question in the negative, the first court to decide the issue concluded in In re UNR Industries that they have not. The UNR court, however, failed to consider a number of factors that weigh heavily in favor of interpreting the Code to reach future tort claims.

First, the statutory definition of “creditor” appears to reflect poor drafting rather than a clear intent to preclude future tort claims from participation in an early reorganization. An interpretation of this definition that included only noncontingent claims would render the definition inconsistent with other Code provisions, the legislative history and basic bankruptcy policies. The Code requires contingent claims to be estimated when the delay needed to

143. Should future tort claims be excluded from bankruptcy proceedings, the reorganized firm would remain liable to pay those claims as they matured. Under these circumstances, the firm probably would exit from bankruptcy without a confirmed reorganization plan and therefore without any of its debt reorganized. A court has no authority to confirm a plan if it is likely to be followed by liquidation or further financial reorganization. Bankruptcy Code § 1129(a)(11).


145. Id. at 744-46. See also In re Gladding Corp., 20 Bankr. 566, 568 (Bankr. D. Mass. 1982) (“a mere possibility of a [tort] claim of unknown origin, in an unknown amount, and which only might arise, if at all, at some unknown time” is not resolveable in bankruptcy); Report of Bankruptcy Judge [to District Court], In re Amatex Corp., 30 Bankr. 309, 315 (Bankr. B.D. Pa. 1983) (recommended to district court that guardian ad litem not be appointed for future asbestos claims in reorganization proceedings of Amatex because “unknown, future, asbestos claimants do not hold ‘claims’ as defined by the Bankruptcy Code”), aff’d, No. 83-0011 (E.D. Pa. Nov. 7, 1983); cf. Bittner v. Borne Chem. Co., 691 F.2d 134 (3d Cir. 1982) (a noncontingent tort claim of some probabilistic value was disallowed after it was judged not likely to succeed, but the bankrupt firm was not discharged on the claim).

Bittner can be distinguished from the mass tort cases. The lower court in Bittner held that on the merits the debtor would have no liability on the claim. That is, the court found it more likely than not that the claimant would fail in state court. In the mass disaster cases this judgment might be made with some certainty regarding any particular claim. But the court would have to conclude that the debtor was likely to face substantial liability, viewed in the aggregate.

146. Two courts have recently suggested in dicta that they might construe the Code differently from the UNR district court, were they to reach the issue. In re UNR Indus., 3 Bankr. L. Rep. (CCH) ¶ 69,589, at 84,184 (7th Cir. Jan. 17, 1984) (Posner, J.), the Seventh Circuit dismissed the appeal from the UNR lower court decision as insufficiently final, but stated that the question whether contingent tort claimants have rights in bankruptcy “is an open one in our minds.” The court went on to discuss supporting arguments paralleling in part those set forth infra notes 147-61 and accompanying text.

One week after the Seventh Circuit announced its decision, the bankruptcy court hearing the Manville Corporation case refused to dismiss Manville’s petition in bankruptcy and decided that it was appropriate to appoint a legal representative for the contingent claimants. In re Johns-Manville Corp., 3 Bankr. L. Rep. (CCH) ¶ 69,615 (Bankr. S.D.N.Y. Jan. 23, 1984) (decision and order on motions to dismiss Manville’s chapter 11 petition); In re Johns-Manville Corp., ¶ 69,700 (Bankr. S.D.N.Y. Jan. 23, 1984) (decision and order on motion to appoint a legal representative for future claimants). Judge Lifland’s decision to appoint a representative was not based directly on an interpretation of the statutory term “creditor.” Instead, the judge noted that regardless of whether future claimants are statutory creditors, they clearly will be affected by the reorganization. As such, they are parties in interest who may be heard under the Code. See Bankruptcy Code § 1109(b) (“A party in interest ... may raise and may appear and be heard on any issue in a case under this chapter.”). Judge Lifland also did not find the UNR district court’s statutory construction compelling. See In re Johns-Manville Corp., 3 Bankr. L. Rep. (CCH) ¶ 69,700, at 84,294 & n.6 (Bankr. S.D.N.Y. Jan. 23, 1984).
resolve the uncertainty would preclude an early reorganization.147 Some contingent claimants must be creditors; otherwise, this estimation requirement would be superfluous. Nothing in the Code clearly indicates that this group of contingent claimants does not include contingent tort claimants.

Indeed, the legislative history indirectly suggests that those claimants should be included. It states that the Code's use of the "broadest possible definition [of 'claim'] . . . contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."148 Bringing all claims into bankruptcy fosters equality of treatment for creditors, which we have seen is a valid albeit weak norm in tort-based bankruptcies. The legislative history goes on to indicate that this broad definition "permits the broadest possible relief in the bankruptcy court."149 This observation favors interpreting apparent inconsistencies in the Code in ways that effectuate the strong norm of debtor rehabilitation. The legislative history thus embodies basic bankruptcy principles that we already have seen weigh in favor of early reorganization.150

Second, even assuming that the UNR court has correctly interpreted the Code's definition of "creditor" to narrow the range of claims compensable in bankruptcy proceedings, the statutory framework suggests that the narrowing can be accounted for more convincingly than by an interpretation that ex-

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147. Bankruptcy Code § 502(c)(1).
148. Senate Report, supra note 140, at 22, reprinted in 1978 U.S. Code Cong. & Ad. News 5787, 5808; House Report, supra note 140, at 309, reprinted in 1978 U.S. Code Cong. & Ad. News at 6266 (emphasis added). This statement referred to a definition of "claim" that would have included many equitable remedies not in the enacted definition; the right-to-payment section, however, was substantively unchanged.
149. Senate Report, supra note 140, at 22, reprinted in 1978 U.S. Code Cong. & Ad. News at 5808, quoted in UNR, 29 Bankr. at 745 n.4. The UNR court misread this statement to conclude that contingent claims were limited to contractual contingencies, such as those to reimburse guarantors. This reading is seriously flawed. The Senate committee report only states that a guarantor is included within the group of contingent claimants. It does not say that guarantors are the only group included. The legislative statement seems to have been offered only as one example of how the new Code would resolve all the debtor firm's obligations in one proceeding.
150. See supra notes 18-46 and accompanying text.
cludes contingent claimants. After the petition is filed, and before a reorganization plan is confirmed, the firm will continue to operate and incur new obligations for material, labor and monies borrowed. If these obligations were forced into the reorganization scale-down—in which their payments would be reduced pro rata, along with those on prebankruptcy claims—those goods and services would not be provided to the debtor. The Code instead contemplates separate treatment for these postpetition obligations;151 ordinarily they would be paid in full. These claims, arising from the bankrupt’s activities after the petition is filed,152 may well have been the type of claims that Congress would have wanted excluded from the definition of “creditor.”

Third, although perhaps less compelling, in some jurisdictions a cause of action accrues for some purposes—and therefore a “right to payment” in some sense has arisen—at the time of reorganization for some or all contingent tort victims.153 Similarly, intentional and wantonly reckless torts would give rise to present claims, although the damages would be nominal—six cents under the traditional formula—absent manifestation of harm.154 In product liability cases, the purchasers of defective products presumably would have contract claims for breach of warranty, although no injury would yet have occurred.155 Contingent claimants with such state-law rights clearly would be creditors under the Code, even if the term “creditor” included only those who could currently bring a state-law action. Once those claimants become creditors in a bankruptcy proceeding, the judge may decline to value their claims on the nominal damages for battery or on the as yet limited contractual damages for breach of warranty; he may instead value them on the expected

152. More precisely, the definition excludes transactions occurring after the order for relief is granted. Bankruptcy Code § 101(9)(a).
chance of affliction with the disease or of injury by the product. The individual claims then would be in the reorganization, ready to be pooled under the framework discussed in Part II.

Finally, the UNR court's narrow reading of the term "creditor" reflects in part its view that the Bankruptcy Code only looks to state-law concepts of what claims have already arisen to determine who is a creditor. But when these state-law notions clash with federal bankruptcy policy—as they seem to in mass tort bankruptcies—precedent indicates that these state-law concepts should not limit the Code's definition of "creditor." Although bankruptcy law usually looks to state law to determine what is a claim, the Supreme Court has held that the issue of whether interest should be allowed to accrue on secured interest claims after the filing of a bankruptcy petition presents a question of federal rather than state law. State law, according to the Court, governs the issue prior to bankruptcy. But once the petition is filed, federal bankruptcy policy prevents the collection of the interest that accrues after the filing and shall determine whether the secured creditor will be compensated for the delay in receiving the interest.

Similar considerations suggest that when federal bankruptcy policy favors early resolution, it should determine how contingent tort victims' damages are calculated and, indeed, whether their claims have already arisen.

156. Cf. In re Tedlock Cattle Co., 552 F.2d 1351 (9th Cir. 1977) (measure of damages for the debtor's fraud determined pursuant to bankruptcy law, not state law).

A similar formula is also available. The tort victim has two claims. One is a present claim for the battery if the requisite intent can be shown, but with nominal damages. He also has a second, future claim for injury, with low expected damages but potentially high actual damages. Once the first claim was established in the bankruptcy proceeding, the second could perhaps be appended. Conceptual support for this "tacking" of claims might come by analogy to the doctrine of pendent jurisdiction, which allows a federal court to exercise subject matter jurisdiction over an issue that it otherwise cannot hear, because the issue is intimately bound to one that the court does have independent authority to hear. See generally United Mine Workers v. Gibbs, 383 U.S. 715 (1966) (state claim may be appended to substantial federal claim, because the two claims formed essentially one "case").

157. This approach works well if there is an identifiable exposed group. It is less effective if future claimants are currently unidentifiable—for example, because they are future passengers of a defective automobile. It is useful even in those instances, however, if the value of the future third-party claims could be "tacked" onto the nominal claims of current users.


159. Id. at 161-63. Vanston is not the only authority for the proposition that state-law notions of property, contract, and claim will not necessarily govern similar notions in bankruptcy if bankruptcy policy conflicts with the underlying state-law bases. See Board of Trade v. Johnson, 264 U.S. 1 (1924) (seat on Board of Trade is property for bankruptcy purposes although not under state law); In re Diversified Dev. Corp., 341 F.2d 58, 59 (7th Cir.) (unenforceable state-law claim not necessarily void in bankruptcy setting), cert. denied, 381 U.S. 951 (1965); In re Searles, 445 F. Supp. 749 (D. Conn. 1978) (what constitutes property of bankrupt estate will be determined consistently with the purposes of the Bankruptcy Act, not blindly according to state common law); In re Groeeland Coop., Inc., 32 Bankr. 427, 432-33 (Bankr. N.D. Ill. 1983) (land trust beneficiary has claim under federal law though not under state law); cf. Hill, The Erie Doctrine in Bankruptcy, 66 Harv. L. Rev. 1013, 1036-50 (1953) (analyzing federal interests in equitably subordinating or disallowing some otherwise valid state-law claims).
Valid state policies exist for refusing to provide a current cause of action until the harm manifests itself. But these policies—such as allocation of scarce court system resources—will not necessarily be impaired by allowing future tort claims to be resolved in the federal courts.

Those fearful of fully federalizing the bankruptcy concept of claim need not be troubled. Since by pooling claims the bankruptcy institutions would only make payments from the pool to those who at some future time have a valid state-law claim, state law would be the final arbiter of whether there was a claim to be paid in bankruptcy. Indeed, the pooling itself would be based on the expectation of future state-law claims. The claims pooling approach would still look to state law to determine whether a claim will probably exist, and to federal law only for the timing of aspects of its resolution.

B. Pooling, Representation and Notice

A pooling of future tort claims in an early reorganization would raise the question whether notice to those claimants regarding early resolution of their claims in bankruptcy is necessary. If it is, no reorganization could take place, since those claimants are for the most part unidentifiable. The question involves both statutory directives on the filing of claims and constitutional due process notice constraints on the disposition of claims. An analysis of the economic relationships involved strongly suggests that notice doctrines should not bar a tort-based reorganization if the tort claimants would take most of the firm's value in the reorganization.

1. Statutory Considerations. — Many future tort victims will not file "proofs" of their claims—assuming that they are viewed as statutory creditors—as required by the Code. Any notice of bankruptcy given is unlikely to reach everyone who has been or will be exposed to risk. Even if all potential claimants receive notice, many may fail to act upon it. Many future claimants may not know that they have been exposed to a risk. To those that are aware, the possibility of harm may seem too remote to make filing claims worthwhile—particularly in light of the barriers to filing arising from difficult-to-understand documents and the need for expensive legal assistance. Claimants may find the possibility of cancer or birth defects so disconcerting that it inhibits their giving the matter the attention it deserves. Individuals, more-
over, often disregard serious risks that have a low probability of occurring. If contingent tort claimants cannot or will not file claims effectively, the argument would run, tort-based reorganizations must fail.

The Code, however, is not so inflexible. It allows the debtor firm to file a proof of claim if a creditor fails to make a timely filing. Furthermore, while the firm often could not specifically identify potential tort claimants—for example, all users of a drug sold over the counter—the Code does not explicitly require such specificity. Indeed, when creditors are collectively represented and their claims are pooled in bankruptcy proceedings, specificity serves no necessary purpose.

164. See supra note 114.

165. But see Bankruptcy Code § 1141(d) (discharging bankrupt from all debts arising before plan confirmation, whether or not a claim was filed for such a creditor).

166. Bankruptcy Code § 501(c). Those jointly liable with the debtor firm may also file proofs of claim. Id. § 501(b). In mass tort reorganizations, those facing contingent joint liability with the debtor would themselves be future claimants for future contribution, but would be unlikely to be subject to the informational and transaction-cost barriers to effective filing of proofs of claim by individuals. See supra text accompanying notes 163–65.

167. The Code in fact contemplates the filing of claims by indenture trustees on behalf of creditors whom they represent. See id. § 501(a). We have seen that the claims pooling approach resembles the bond indenture in the collective character of the representation. See supra note 20; cf. Bankruptcy Code § 1111(a) (undisputed, noncontingent claim listed by the debtor is deemed filed, without action by creditor). To satisfy § 1111(a) a contingent claimants’ representative would have to file proofs of claim on their behalf after getting notice. See In re Rice Autotronics Corp., 27 Bankr. 599, 602–03 (Bankr. 9th Cir. 1982) (§ 1111(a) prevents resolution of disputed or contingent claims without giving due process notice to claimant); In re American Properties, Inc., 30 Bankr. 239, 244–45 (Bankr. D. Kan. 1983) (creditor has right to adequate notice before its claim is forever barred).

168. Other statutory inconveniences would arise, but they do not seem to pose a decisivebar to the claims pooling approach. After the claims are filed, a reorganization plan must be proposed and confirmed. In general, the requirements that concern plan contents deal principally with the treatment of claimants by classes rather than individually. See Bankruptcy Code § 1123(a). As such, those requirements pose no significant barriers to pooling. All class members must be treated similarly, however, absent consent. Id. § 1123(a)(4). This constraint should not present a serious obstacle. Compensating each claimant based on the ratio of aggregate expected claims to firm or pool value at the time that the claim is presented for redemption should be considered equal treatment, even though different ratios in use at different times may yield differing levels of compensation.

Plan confirmation depends on either the nonimpairment of a class of claims, the consent of the class of claimants, or the “cram-down” of the class of claims. Nonimpairment essentially requires that the claims be paid in full—which is obviously unlikely here. As for consent, those who do not even know that they are claimants can hardly consent to confirmation. Since the Code contemplates that the usual reorganization be settled by bargaining among classes for a consented-to plan, a reorganization by pooling may seem at odds with the statutory framework. The claimants’ representative in the reorganization, however, could bargain for and thus consent on behalf of the class. But see The Effect of Bankruptcy Cases of Several Asbestos Companies on the Compensation of Asbestos Victims: Hearings Before the Subcomm. on Labor Standards of the House Comm. on Education and Labor, 98th Cong., 1st Sess. 30–32 (1983) (comments of Professor Lawrence King) (warning that due process may require a chance for participation in bankruptcy plan by future claimants to bind them to it) [hereinafter cited as House Compensation Hearings]. Alternatively, the tort victims could be viewed as having rejected the plan, or at least as
2. Constitutional Considerations. — The district court in In re UNR Industries\(^{169}\) rested its decision that claims could not be pooled in part on constitutional grounds.\(^{170}\) On the constitutional issue, the court stated that a claims-pooling framework would be fatally defective because it would deprive unidentified contingent claimants of their due process rights to actual notice of the reorganization that would affect their claims.\(^{171}\) This is not the place for a full-scale review of the due process notice doctrine. We will, however, examine crucial economic considerations and their implications for due process.

It is true, of course, that in general due process requires that parties to judicial proceedings receive the best notice reasonable under the circumstances.\(^{172}\) But under the circumstances involved here—potential liability to a mass of individuals only some of whom will ultimately be claimants, with that liability potentially exceeding the firm’s worth—the value of individualized, actual notice to the fundamental concern of due process—fairness of procedure—is quite dubious. Indeed, an analysis of the economic realities—without making an exhaustive inquiry into precedent—suggests that actual notice ought to be neither a necessary nor sufficient prerequisite to a fundamentally

not having consented to it. The court then could “cramdown” the plan—that is, force it on those claimants—after valuing the firm and the amount allocable to the tort claimants. If the court concluded that as a class they had received the proportionate amount due them, the court could confirm the plan, regardless of whether the tort claimants or their representative had given consent. Bankruptcy Code § 1129(b)(2). The nature of the representative’s position, as I suggest in Part IV, will systematically dispose him to withhold consent, thereby forcing a judicial valuation and “cramdown,” a method of reorganization disfavored by the Code. This prospect presents serious problems, but they are not questions of statutory construction. See infra notes 188–98, 213–29 and accompanying text.

The class of future claimants will experience internal conflicts: some will present claims earlier than others, and some will have been exposed to disease under circumstances that will create differing liabilities. These conflicts may lead courts to decline to certify class actions. See Yandle v. PPG Indus., 65 F.R.D. 566, 572 (E.D. Tex. 1974). In In re UNR Indus., 29 Bankr. 741 (N.D. Ill. 1983), appeal dismissed, 3 Bankr. L. Rep. (CCH) ¶ 69,589 (7th Cir. Jan. 17, 1984), the court suggested that the apparent inability to certify a class under Fed. R. Civ. P. 23 would undermine the appointment of a future claim representative under the Bankruptcy Code. 29 Bankr. at 746–47. Whether class action doctrines need be satisfied or whether they could be satisfied by multiple representation is not a subject of this Article. See Rosenberg, The Causal Connection in Mass Exposure Case: A “Public Law” Vision of the Tort System, 97 Harv. L. Rev. 849, 909–19 (1984) (advocating broadened class actions in mass tort cases).


170. The court’s statutory holding is discussed supra notes 139–61 and accompanying text.

171. 29 Bankr. at 747–48; see also Manville Reporter, supra note 58, at 2272 (March 19, 1984) (reporting statement of District Judge Motley that the Manville case “raises serious due process questions as to whether [a representative could] affect the rights of [future] claimants”); House Compensation Hearings, supra note 168, at 30 (reporting similar comments of Professor Lawrence King, an authority on bankruptcy). The Code itself is quite flexible on what notice need be given. It requires only “such notice as is appropriate in the particular circumstances.” Bankruptcy Code § 102(1)(A).

fair procedure. Due process in certain mass tort cases—when the value of the firm is set aside for the unidentified future claimants—ought to be satisfied by the appointment of a future claimants' representative, without requiring actual notice.

If actual notice were required but impossible to provide, the alternative would be to delay resolution of the claims; nothing could be done to affect such claimants until they were actually notified of the proceeding. Delay would be plausible if the aggregate contingent tort liability were small in relation to firm value. In those circumstances, future claimants could be reasonably sure that the firm would be able to pay their claims once they had matured. But in cases in which contingent tort claims exceed firm value, a blind invocation of due process notice constraints will defeat the economic interests of those whom the notice requirements are invoked to protect. An exclusion of such a massive level of claims from a reorganization because of an inability to notify the claimants makes little sense. Every action of the enterprise could affect those claimants' economic interests. Indeed, such an invocation of notice requirements in effect would shift the forum for controlling the flow of value to the claimants from the bankruptcy court to the firm's management and the local tort system. Moreover, a delay in reorganization would risk the deterioration—quite possibly the operational collapse—of the firm, the value of which provides compensation for contingent tort claimants. Surely due process cannot deny the assertion in bankruptcy of a future claim in the face of a serious risk that little or nothing will be left to satisfy the claim when it is eventually reduced to judgment. Due process cannot be so ironically self-defeating.

The Supreme Court has analyzed the notice required by due process in a manner that would lead to a result precisely contrary to that reached by the district court in UNR. In Mullane v. Central Hanover Bank & Trust Co., 173 the Court said that due process does not always require actual notice. A court in applying the constitutional standard must have "due regard for the practicalities and peculiarities of the case." 174 In Mullane, a representative had been appointed to represent the unborn, unknown and contingent beneficiaries of a complex trust; actual notice was impossible. 175 Nevertheless, the Court stated that the potential claims of unknown claimants for trust mismanagement could be settled in a judicial accounting proceeding by giving constructive

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174. Id. at 314. The Court also stated that [personal service of written notice . . . is the classic form of notice always adequate in any type of proceeding. But the vital interest of the State in bringing any issues as to its fiduciaries to a final settlement can be served only if interests or claims of individuals who are outside of the State can somehow be determined. A construction of the Due Process Clause which would place impossible or impractical obstacles in the way could not be justified.

Id. at 313-14 (emphasis added).
175. Id. at 310-11.
notice. Representation thus can be seen as a constitutionally acceptable surrogate for actual notice in at least some cases in which actual notice cannot be given. There may be intermediate cases, of course, in which the contingent tort claims represent a significant portion but not nearly all of firm value. A crucial issue in such reorganizations is how much of the firm's value should be set aside for the future claimants. As we will see, claimants may be poorly represented on a systematic basis under these circumstances. But here again,

176. Id. at 314-18. The Court did go on to note that many of the identifiable beneficiaries, who would receive actual notice, were reasonably good surrogates in advancing the Interests of those not identifiable. Id. at 319. For a tort-based reorganization such as that discussed in this Article, other claimants are not likely to be especially good surrogates for the future tort claimants. See infra notes 205-12 and accompanying text. Mullane also involved the pooling of trust funds under new state authority. The pooling plan was likely to provide some benefit to each beneficiary through administrative efficiencies and investment diversification, and involved little chance of ousting the beneficiary. These factors distinguish Mullane factually from a tort-based reorganization. In the latter, the size of, and compensation for, the claim is to be determined. A greater range in financial outcomes than in Mullane is likely.

 Cf. Mennonite Bd. of Missions v. Adams, 103 S. Ct. 2706, 2711 (1983) ("[U]nless the mortgagee is not reasonably identifiable, constructive notice alone does not satisfy the mandate of Mullane") (footnote omitted) (emphasis added); Hatch v. Riggs Nat'l Bank, 361 F.2d 539, 566 (D.C. Cir. 1966) (no due process issue suggested by court when requiring consent of all potential beneficiaries as a prerequisite to settlement of a trust if unknown beneficiaries were to be represented by a guardian; "[T]hough the persons whose interests the guardian ad litem represents would be unascertainable as individuals, they are identifiable as a class and their interest, as such, recognizable"; facts indicate that there were partial surrogates) (Leventhal, J.). See generally 2A Powell on Real Property § 296 (1983) (authorizing various legal devices used to protect interests of unborn); Note, Trusts: Modification of Irrevocable Trusts Through Appointment of a Guardian for Unborn Heirs—Repetition of Worthier Title Doctrine, 66 Colum. L. Rev. 1552, 1556-59 (1966) (courts frequently appoint guardian ad litem to represent interests of unborn).

177. Pooling the claims in the bankruptcy proceeding does not require that the firm's liability on individual claims be determined at the time of pooling. The court could aggregate the claims and reserve for later judicial determination the firm's liability on each claim. Claimants would sue as their claims accrued. After trial, they would present the claim to the pool manager for compensation, which would take the form of the pro rata inalienable, but annually redeemable annuity. See discussion supra notes 51-80 and accompanying text. The due process problem may be bound up with proposals to substitute a centralized schedule of damages, similar to that used in worker's compensation schemes, for traditional but costly individual trials in mass tort cases. Standardization also would raise questions of the applicability of the Code's partial guarantee of preexisting jury trial rights. 28 U.S.C. § 1480 (Supp. V 1981). If litigation costs are likely to take a substantial fraction of firm value, as has been alleged, see, e.g., Manville and UNR House Hearings, supra note 19, at 103 (statement of Malcolm M. Caynon, Esq., reorganization counsel to UNR Industries), there is much to say for replacing the trial system with standardized awards.

The issues of administrability and the possibility that a full adversarial hearing would provide more than would a schedule of awards have been remarked on elsewhere. See Note, Procedures, supra note 55, at 158-73. These issues are not the subject of this Article. An approach based on early reorganization and pooling of claims is consistent with either standardized or individualized determinations of damages.

178. See supra notes 81-131 and accompanying text.

179. See infra notes 187-230 and accompanying text.
a delay in resolving their claims will not necessarily safeguard the future claimants' economic interests. Decisions that affect the firm's finances will be made, whether by the reorganization court or by the corporation in negotiating with its creditors and in paying dividends. The status quo clearly will not be preserved pending maturity of future claims. On balance, as previously discussed, an early reorganization often will further the future claimants' interest more than will delay, and it is difficult to tell in advance which reorganizations will undermine those interests. Even in these intermediate cases the usual constitutional requirement of notice is of dubious value to contingent tort claimants.

Moreover, notice if given may well be ineffective. We noted when discussing the Code's claims filing procedure that future tort claimants may not respond to actual notice because they do not know that they have been exposed to risk, because they refuse to evaluate risk well, or because practical barriers to pressing their claims seem to outweigh the contingency.

These problems of ineffectiveness make the value of notice questionable. They are augmented by a significant "free rider" problem that seems to have escaped the attention of the district court and the parties in UNR, perhaps because the individual accrued tort claim often is large enough—$50,000 or more in the asbestos cases, for example—to support the expenses of litigation. The play of economic interests suggests, however, that the contingency of even substantial future tort claims would be likely to make actual notice largely worthless, even to those claimants who are aware of the risk and are capable of evaluating it well.

In mass litigation, individuals often will take a "free ride"—that is, take advantage of the efforts of groups that seek to obtain indivisible benefits. Participation will cost an individual claimant something. If nonparticipation will not reduce the claimant's benefits if the group wins, nor significantly

180. See supra text accompanying and following note 172.
181. Although to blindly invoke a notice requirement would ignore the economic realities that make actual notice useless when claims overwhelm firm value, that supposed requirement need not defeat all aspects of an early reorganization. The "purgatory" alternative—by which the firm's assets would be held together without any immediate payout to creditors, see supra notes 114-22 and accompanying text—could be used until either expected claims were certain to overwhelm firm value or the claimants could be identified and actual notice given. Alternatively, the going concern sale discussed supra note 63 could be used. The firm's operations would be sold and the proceeds held for distribution until there was greater certainty or actual notice could be given. (But offsetting, unwanted transaction costs will be incurred: little could better attract the American legal community and its attendant costs than a very large cash fund of uncertain ownership.)
182. See supra notes 163-65 and accompanying text.
reduce the chances of winning in light of the minute incremental impact of the individual's failure to help, then the claimant has no economic incentive to participate. If every group member decides not to participate, the group's prospects may suffer, even though aggregate group costs are much less than group benefits. Suppose 100,000 people are exposed to a carcinogen that will give cancer to 1,000, causing each to suffer $50,000 in damages. What motive does any member of the exposed population have to enter the reorganization fray and litigate, even assuming perfect notice, complete evaluation of information, and ample personal finances? The answer, of course, is very little. The expected value of each individual's damages, $500, 185 will finance little litigation; even the well-informed are motivated simply to rely on others to decide whether to sue. Thus, given even minimal transaction costs, one could expect actual notice to be useless. 186 Substantial tort claims would then go unasserted and unrepresented.

A pooling of the individual claims provides the economic incentive to litigate the claims. Although contingent-fee arrangements with lawyers specializing in such litigation, union representation of exposed employees, or class actions might occasionally provide a satisfactory mechanism, these procedures may be unavailable or may fail to provide for a complete resolution of all claims, particularly since they may only accommodate current not contingent claimants. A pooling of claims and appointment of a future claimants' representative then would seem to be not merely an adequate substitute for actual individual notice, but procedurally superior to it. A sensible due process doctrine would not insist on wooden requirements that delay resolution, which could seriously imperil the future claimants' economic interests when the expected value of their claims is a large portion of firm value. Instead, it should seek to pool those claims in an early reorganization, to serve best precisely those interests that due process should protect. Notice is neither necessary nor sufficient for adequate procedural due process.

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185. $\text{Expected individual damages} = \frac{\text{Number of actual victims}}{\text{Number of persons exposed}} \times \text{Actual individual damages}$

$= \frac{1000 \times 500}{100,000} = 500$

186. This is not to say that such individuals if given notice will never pursue such claims. I may make the "rational" calculation that the expected value of my claim is $500 and then spend $10,000 to get back at those who exposed me to a carcinogen. For those who will react in this fashion, actual notice is not at all useless. But it seems doubtful whether enough claimants would react this way, and whether those who did could coordinate their indignant energy sufficiently to prevent practical dissipation of their efforts absent a legal structure for pooling their claims.
IV. Strategic Reaction by Interested Parties

That a pooling of future tort claims in an early reorganization would follow from application of the basic principles of creditor equality and debtor rehabilitation seems clear. Practical devices based on the pension fund, the bond indenture and the variable annuity seem capable of implementing these norms effectively. Neither the Code nor constitutional due process should bar implementation.

Thus an early reorganization is plausible for the firm overwhelmed by tort claims, so long as that firm is already in the grasp of the bankruptcy courts. But to stop here would ignore a crucial question: how will an enterprise get into such a tort-based reorganization? This we will see poses the knottiest problem arising from the intersection of bankruptcy and tort. If we are unable to find a satisfactory means of triggering reorganization, the claims-pooling approach may be a policy solution that is limited to those reorganizations that have already begun or that may occur for unrelated reasons.

A. Who Will Pull the Reorganization Trigger?

Stockholders, management, contract creditors and current tort claimants make up the four groups that can trigger reorganization under the present Code. Complex and conflicting motivations will inform the decision of each group to seek reorganization. An examination of these interests reveals drawbacks in any solution that relies on any of these actors to force the firm into bankruptcy. These conflicts run sufficiently deep that no complete, perhaps even no satisfactory, solution is possible. But some of the problems that are likely to arise can be mitigated by allowing public agencies or contingent tort claimants to begin a reorganization if they can demonstrate to the court that the value of the aggregate contingent claims is a large portion of firm value. These conflicts also suggest that in some instances the firm should not be discharged on its contingent tort liability.

1. Stockholders. — Clearly, if stockholders possess full control over corporate machinery, they often will prevent a reorganization that is worthwhile from a firm-wide perspective. That they will do so, or will exact a price for their consent to a finance-based reorganization that would otherwise deprive them of all or most of their equity, has not gone unnoticed by the courts. Much the same problem would be presented in a tort-based reorganization. If the claims on the firm exceed the firm's average, expected value, the stockholders have nothing to lose by delaying reorganization. The firm

187. Contingent claimants are denied this power under the current code. See Bankruptcy Code § 305.

188. See, e.g., Goldman v. Postal Tel., Inc., 52 F. Supp. 763, 771 (D. Del. 1943) ("Delaware courts have recognized the strategic position of common stock to hamper the desires of the real owners of the equity of a corporation, and the tribute which common stock exacts for its vote under reclassification and reorganization."); see also Model Business Corp. Act §§ 73, 79 (1982).
may unexpectedly grow in value, or tort claims unexpectedly diminish in severity, to a point where the firm could pay off claimants and leave something for stockholders. Diversions of value might be made, for example, through nonrecoupable dividends, before future claimants bring suit.

The general problem of owner resistance is met by the Code in two ways, neither of which is clearly useful in the mass disaster setting. First, contract creditors can force a reorganization when the firm is experiencing ongoing cash flow problems. Long-term contract creditors can negotiate covenants that allow them to accelerate their debts' maturity under a wide variety of circumstances, and thereby satisfy the Code's cash flow requirement. Upon this acceleration, the firm would be forced to pay or reorganize. Contingent tort claimants, however, cannot force a reorganization; moreover, tort claimants in general cannot bargain for such a set of covenants. And as we will see, contract creditors will not serve as adequate surrogates for tort claimants.

189. Unwarranted optimism could give rise to the incentive to delay, but it is not at all necessary. Recall that expected firm value and expected aggregate claims value are weighted averages of probabilities. See supra notes 82, 83, 124 & 125 and accompanying text. For example, expected firm value and expected aggregate claims value are both $2 billion. Reorganization gives the firm to claimants, wiping out the shareholders' interests. Is delay of value to shareholders? If the $2 billion values were from equal chances of either $1 billion or $3 billion, and firm value and claims value were uncorrelated, see supra note 87 and accompanying text, delay would be quite valuable; there would be a one-in-four chance of a $2 billion payoff.

Ultimate Firm Value

<table>
<thead>
<tr>
<th>Ultimate Claims Value</th>
<th>$1 billion (50% chance)</th>
<th>$3 billion (50% chance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 billion</td>
<td>No payoff for shareholders</td>
<td>$2 billion for shareholders</td>
</tr>
<tr>
<td>$3 billion</td>
<td>No payoff for shareholders</td>
<td>No payoff for shareholders</td>
</tr>
</tbody>
</table>

The half-billion dollars in expected value would give an incentive for delay.

An additional basis for delay in tort-based reorganizations may be to lobby for change in the standards for tort liability to make them more favorable for defendants. Cf. Saddler, Bill Limiting Firms' Liability Gains in Senate, Wall St. J., Mar. 25, 1984, at 2, col. 2 (discussing congressional action).

190. In some instances, current stockholders may prefer to delay reorganization so that they might in the interim sell their stock to those less well-informed about the severity of the potential tort disaster.


194. As suggested supra note 20, a sensible bankruptcy statute might provide the tort claimants with a basic minimal set of covenants similar to the bond indenture. See infra notes 231-36 and accompanying text for a draft of such terms. That is, the problem of owner resistance to a tort-based reorganization could be mitigated somewhat by legislatively mimicking the reaction of contract creditors to this problem.
Second, the Code contemplates that senior creditors bargain with junior interests, if necessary paying them to refrain from causing delay. A representative for contingent claimants would be under pressure to act similarly during negotiations over the reorganization plan’s substantive contents. But a future claimants’ representative may less willingly give up value to buy off the juniors. If so, the Code’s negotiation framework will not hold up well. For example, the representative, mindful of potential liability for negligent representation, may prefer a complex, expensive valuation hearing that judicially “validates” the result. The representative might conclude that a decision to give up something to stockholders in return for a quick termination of the proceedings may be more difficult to defend in a later lawsuit than a decision to delay, even though in his judgment settlement seems likely to maximize the compensation that future claimants receive. Without the representative’s consent, a valuation hearing would be needed and a judge hewing to the absolute priority standard would have to provide for contingent tort claimants in full before stockholders receive a dime.

This potential propensity for an expensive, time-consuming valuation hearing instead of a negotiated agreement is itself a debility. During its course, the firm’s operations could deteriorate, so that the contingent tort claimants receive less value than they would have received in an earlier, bargained-for settlement. But the problem that such a procedure poses is yet more pernicious. The valuation and distribution of firm value under the absolute priority standard often would wipe out the stockholders. Fearful of such a result, stockholders often may refuse to trigger a reorganization.

This is not to say that stockholders would never trigger a reorganization. They may err in assessing the value of the firm or the aggregate claims. They may conclude that a better operated, reorganized firm would provide them with enough extra value spilling over from the creditor layers to more than offset what they would get from diversion and delay. The Code also permits other diversions of value to shareholders by forestalling the accrual of interest


196. Given the uncertainty of the future firm’s value and of aggregate claims, the representative may fear that a lawsuit will ensure if hindsight later suggests that different values could and should have been used.


198. Courts have deviated from absolute priority by overvaluing the firm, it is said, in order to include stockholders. See Note, Absolute Priority Under Chapter X—A Rule of Law or a Familiar Quotation?, 52 Colum. L. Rev. 900 (1952). But stockholders cannot count on this tendency in a tort-based reorganization. Judicial sympathy for stockholders over contract creditors, it has been suggested, is responsible for this overvaluation. Blum, The Law and Language of Corporate Reorganization, 17 U. Chi. L. Rev. 565, 569 (1950); Brudney, The Investment-Value Doctrine and Corporate Readjustments, 72 Harv. L. Rev. 645, 686–87 (1959). It is unclear to me, and I suspect it would be unclear to stockholders, whether that sympathy would survive if the choice were between stockholders and tort victims.
on many claims during reorganization, allowing the rejection of executory contracts that have turned out to be a burden to the bankrupt, and generally staying actions against it. These diversions of value sometimes may be more attractive to stockholders than the diversion outside of bankruptcy by delay.

Stockholders that are close to the firm, moreover, may prefer reorganization in light of information not publicly available. Suppose that although generally available information indicates some level of liability that would result in the tort claimants taking one-quarter of the firm in the reorganization, the stockholders’ private information indicates that tort victims otherwise would take the whole firm over the next ten years. Stockholders may prefer an immediate reorganization that would resolve currently expected tort claims and allow stockholders to keep three-fourths of the firm. If this possibility poses a serious problem, tort-based reorganizations could be restricted to those in which the tort victims would take some large portion of the firm. Nevertheless, there is a substantial risk that reliance on the stockholders to pull the reorganization trigger would be reliance principally on stockholder miscalculation, on their appraisal of alternative diversions of value, or on their assessment of spill-over value from better operations against value from diversion and delay. These stockholder motivations form a shaky foundation for tort-based reorganizations.

2. Management. — Management occasionally may be superior to stockholders in making the decision to trigger bankruptcy but often they would not. An owner-managed firm usually would decide to trigger bankruptcy only if it would advance stockholders’ interests. Even for a public firm with a management distinct from its ownership, management may have motivations like those of stockholders.

199. Bankruptcy Code §§ 502(b)(2), 506(b), 726.
200. Id. §§ 362, 365.
201. A variation would impose high burdens of proof on the accuracy of aggregate claims and firm valuation if the tort claimants will take a low portion of the firm, and lower burdens of proof when the result would be that they take all or most of the firm. Alternatively, low-value aggregate tort claims might not be discharged at all.
202. Stockholders, after all, sometimes do exercise control. M. Eisenberg, supra note 35, at 43–51. Management, even if independent, may be acculturated to act on the stockholders’ behalf. Moreover, even when managers do not own a controlling block of stock, a substantial portion of their personal wealth may be tied up in the firm’s stock. As stockholders themselves, they may not favor early reorganization.

Cf. Manville and UNR House Hearings, supra note 19, at 99–100 (statement of Malcolm M. Geynor, Esq., reorganization counsel to UNR Industries) (“A Chapter 11 . . . solution will most certainly result in substantial restructuring of the interests of shareholders in favor of creditors, including the asbestos claimants. In other words, the interest[s] of all shareholders of the company, including Mr. Leavitt [UNR’s chief executive officer] are on the line.”). Manville Corporation’s management, on the other hand, has an unusually low ownership interest in the corporation. See Manville Corp., 1982 Annual Report and Form 10-K, at 64. This lack of ownership suggests that the management of other firms faced with toxic torts may not turn to bankruptcy with as much alacrity as did Manville’s.
What of managers’ role as managers? To the extent that managers depend on the viability of the firm for continued employment and professional reputation, they will make a dispassionate judgment based more on operational than on distributional considerations. That is, they would weigh the operational costs of unresolved claims against the operational costs of a bankruptcy proceeding, a balancing that is more socially useful than that made by stockholders.

But even when managers are acting for themselves, they often may weigh primarily short-term costs and benefits. If so, they will systematically tend to favor delay. Bonuses and promotions are based on current year’s profits and sales. Rewards for reducing the costs of a distant and uncertain disaster are not likely to come often. Indeed, for some managers, doing so would reveal or call attention to their misdeeds and omissions.203

203. This possibility suggests that early resolution of tort claims could have some beneficial effects for tort policy. Although we can sketch the issues here, more detailed treatment would be necessary for their proper resolution.

Tort-law theory, as one of its goals, has sought to place liability in a manner that best deters unwarranted risky behavior. See generally G. Calabresi, supra note 64; Pierce, Encouraging Safety: The Limits of Tort Law and Government Regulation, 33 Vand. L. Rev. 1281, 1288 (1980). But cf. Blum & Kalven, The Empty Cabinet of Dr. Calabresi: Auto Accidents and General Deterrence, 34 U. Chi. L. Rev. 239, 246-59 (1967) (suggesting difficulties in doing so).

But the placement of liability on the manufacturing enterprise, even if otherwise well-thought out, may not achieve the objective of deterrence; corporate managers may assess the risks in light of their own interests, which due to their short-term goals may not lead to a result consistent with the social calculus. Development of a drug that will save lives today and generate immediate profits but years later pose grave risks to users will get the manager-developer promoted and keep stockholders—who are unaware of the risks a decade to come—happy. The manager may not even take time to become acquainted with those risks, or may underresearch them. Even if the manager is aware of those risks, he may decide to ignore them or take feeble precautions. After all, he may be gone—to another firm or into retirement—when the risks materialize. In any case, furthering his career is a current concern; one can worry about long-term risks later. See generally Stone, The Place of Enterprise Liability in the Control of Corporate Conduct, 90 Yale L.J. 1, 15 n.59 (1980).

The potential usefulness of a bankruptcy reorganization in implementing a deterrence policy should be clear. By bringing the costs of a mass disaster forward in time, the reorganization may change the manager’s personal calculus, bringing it more in line with the social calculus. A few tort claims in the five years subsequent to the drug’s introduction may be inconsequential in the manager’s balance—and, sad to say, sometimes in the social balance of lives saved against defects caused as well. But those claims, when considered together with projections of a large, aggregate ten-year claim level, may provide the basis for a reorganization in bankruptcy within five years of the drug’s introduction. The manager may not be able to ignore five-year risks safely. Angered stockholders at that time may oust management entirely. Even if most of management stays, the decisionmaker may be fired. A reorganization may lead to the ouster of old, friendly stockholders. The new stockholders may not look kindly on the newly revealed errors of the old management. More particularly, if reorganization resulted in the victims owning the firm—even if only temporarily—old management’s tenure would be quite precarious.

Further thought and empirical observation, however, would be needed to determine the actual impact of a bankruptcy-based approach to deterring risky and undesirable behavior. For example, whether the managerial calculus is successfully reformed will depend on enterprise size
Thus the elements of the managerial decision whether to trigger reorganization would be complex. On one hand, management would tend to trigger reorganization when it feared the future would reveal a greater value for contingent claims than outsiders currently expected, and thus pose a greater risk to management of upsetting their corporate system. Management would also pull the trigger when it felt threatened by the difficulties of operating a firm subject to the bleeding sore of continuing, unresolved contingent claims. On the other hand, management would tend to refrain from reorganization when it feared that reorganization would be more costly than leaving future claims unresolved, that managerial error would become known within and without the firm, that its modus vivendi with current stockholders would be upset, or that the reorganization would produce new stockholders hostile to the current management. In brief, although management’s judgment seems slightly preferable to that of the stockholders in determining when to pull the trigger, management’s self-interest is hardly likely to allow a socially optimal decision.

3. Contract Creditors. — One might think that contract creditors would act as adequate surrogates for contingent future claimants. Many firms have contract creditors with claims maturing far in the future. Those claimants typically are armed with bond indenture covenants that enable them to force a current reorganization. Are such contract claimants subject to the same uncertainties and risks as contingent tort claimants? Are the interests of the two groups sufficiently similar, so that these contract creditors usually would force a reorganization just about when it would benefit the contingent claimants?

The short answer is no. First, some firms, though not many, have little long-term debt. Short-term creditors, such as bank and trade creditors, are paid over a time span of months and are unconcerned with a threat to the firm a decade down the road. Current claimants have no interest in a reorganization that can only dilute their claims. Moreover, even if current claimants

in relation to the risk in addition to the social balance of product cost and benefit. If a risky product were to be introduced by a large firm that could absorb those risks without the threat of bankruptcy, the managerial calculus that ignored many long-term risks would be unaltered. When the risky product is about to be sold by a small firm, the possibility of early reorganization might cause some managerial recalculation of the probability of bankruptcy and ouster.

On the other hand, smallness in enterprise size in relation to the risk might result in a perverse incentive to increase the dollar size of tort risks if there is a present profit in exposing more buyers to future damage, and the probability of the risk and an early reorganization is not thereby enhanced. This incentive parallels the stockholders’ motivation to ignore some risks, due to the shareholders’ limited liability. This problem is also present whenever a potential tort defendant is judgment-proof.

204. If management expected the compensation pool to be diversified quickly in order to reduce risk for future claimants, then this specific risk of an unfriendly shareholder class—but not the general risk of an uncertain and new shareholder class—would be mitigated.

205. Under the bond indenture, a long-term contract claimant can accelerate the maturity of the debt when the firm breaches a contractual covenant, demand payment, and in some circumstances use a subsequent failure to pay to meet the Code's cash flow prerequisite to involuntary reorganization. See Bankruptcy Code § 303(h)(1); supra note 20.
desire a reorganization, the firm can avoid an order for relief under the Code so long as it pays those creditors as their claims mature.\footnote{206}

Second, long-term creditors with large unmatured claims often would prefer \textit{not} to assert their contractual rights to accelerate payment, an act that usually would effectively force a reorganization, especially if contingent claims could be asserted against the debtor firm as soon as it was in reorganization. Contract creditors often would prefer to receive interim interest and sinking fund payments in full, before future tort claims are asserted. Prior to the assertion of the tort claims, contract creditors need not share with the tort claimants; early reorganization could require pro rata treatment of both groups.\footnote{207}

Third, secured creditors receive priority in reorganization distributions, to the extent of the value of their security.\footnote{208} These creditors have a reduced incentive to force a bankruptcy so long as their collateral retains value and they are being paid. Occasionally unsecured contract creditors may be able to take security during a firm’s financial crisis, thereby increasing the likely payout on their claims.\footnote{209} Although some transfers of security may be set aside, often the conditions for doing so will not be met.\footnote{210}

\footnote{206. Bankruptcy Code § 303(b)(1).}

\footnote{207. An example illustrates this point. Assume that a firm borrows $200 million from an insurance company. Half of that principal will be amortized prior to maturity by sinking fund payments of $10 million per year in each of the next ten years, after which the remaining principal becomes due. Contingent claims of $300 million are likely to be asserted against the debtor firm starting nine years in the future. The contingent claims have an expected present value of $200 million. The firm is now worth $200 million and can pay off the sinking fund plus interest during the interim years with reasonable assurance, but firm value will be reduced accordingly. If the insurance company forces a current reorganization, it would obtain $100 million, after splitting the firm proportionately with the contingent claimants. By waiting nine or ten years, it obtains the amortization of about $100 million, then splits the $100 million firm with the contingent claimants—whose claims then would be worth $300 million. Waiting allows the contract claimant to shift $33 million in additional value from the contingent claimants to itself. Only if the contract repayments represent a rate of return well below the market interest rate would the economic interests of long-term contract creditors and future tort claimants converge. The contract creditors then may want to accelerate payment, thereby forcing an early reorganization. But see Bankruptcy Code § 1124(2).}

\footnote{208. Bankruptcy Code §§ 507, 724(b)(1), 1129(b)(2)(A).}

\footnote{209. See W.T. Grant Co. v. Rodman, 699 F.2d 599, 603 (2d Cir. 1983); P. Nelson, supra note 33, at 100 (bank creditors of W.T. Grant replace a $500 million unsecured credit line with a $600 million secured loan while Grant was in difficulty one year before its eventual bankruptcy). Although the Code sometimes permits this result, taking security often will not be practicable. See supra notes 29–31 and accompanying text. Lenders owed money by UNR Industries requested it to pledge all its assets to them, just prior to UNR’s filing of a bankruptcy petition. Manville and UNR House Hearings, supra note 19, at 99 (statement of Malcolm M. Gaynor, Esq., reorganization counsel to UNR Industries, Inc.). (The uncertainty of the asbestos litigation had led UNR’s accountants to qualify their opinion as to the accuracy of the company’s financial statements. The inability to deliver an accountants’ unqualified opinion was an event of default under UNR’s lending agreements. Apparently the lenders were prepared to waive the default if they were pledged all of the firm’s assets.)}

\footnote{210. Under the Code, the transfer could be attacked as a preference if tort victims were allowed to force a reorganization within 90 days of the transfer. See Bankruptcy Code § 547. The
A portrayal of contract creditors as adequate surrogates for the contingent tort claimants is unconvincing. 211

4. Current Tort Claimants. — One might think that the current tort claimants—if their claims are significant—should be adequate substitutes for the future tort claimants. This is not so, however. The interests of current tort claimants resemble those of current contract creditors—who, as we have seen, are not likely to be adequate surrogates—rather than those of future tort claimants. Current tort claimants ordinarily would prefer to delay reorganization and be paid in full during the interim. If they forced a bankruptcy proceeding in which future claimants participated, they usually would have to share pro rata with future claimants. Moreover, even if current tort claimants desire an immediate reorganization, they cannot force one under the Code so long as the firm pays its debts as they come due. 212

5. Contingent Tort Claimants. — Nor can the contingent tort claimants be relied on to make the reorganization decision. A contingent claimant cannot force a chapter 11 bankruptcy reorganization under the Code. 213 If

current statutory framework does not permit contingent claimants to force the reorganization, however. See id. § 303. The transfer arguably could be attacked as a fraudulent conveyance if the transfer is made in order to hinder or defraud other creditors—i.e., the tort victims. That attack would suffer from two possible defects. First, it is often difficult to prove actual intent. Second, the Code requires that the transferor owe a debt to the tort victims. Id. § 548(b). This prerequisite necessarily involves liability on a claim. Id. § 101(11). But in our example, liability to tort victims is contingent, to occur if at all ten years hence, not during the one-year statutory conveyance period. The alternatives to actual intent require a showing of insolvency or the like, which may be impossible to make if future contingent claims are not reduced to expected present value in the solvency calculation.

The incorporation of state law into the Code’s fraudulent conveyance provisions through Bankruptcy Code § 548(b) would be more promising for tort victims, assuming that they were given the power to force the firm into bankruptcy. Some states have adopted the Uniform Fraudulent Conveyance Act, which provides that “[e]very conveyance made . . . with actual intent . . . to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.” Uniform Fraudulent Conveyance Act, 7A U.L.A. 242, § 7 (1984) (emphasis added). The problem of proof of actual intent would remain, however.

211. See, e.g., Creditor’s Motion to Dismiss, In re Johns-Manville Corp., Nos. 82-B-41156/41157 (Bankr. S.D.N.Y. Nov. 1, 1982) (brief of M.J. Whitman & Co., Inc., supporting motion to dismiss Manville Corporation’s bankruptcy petition) (holders of Manville Corporation notes due five years after date of motion seek dismissal of Manville bankruptcy petition), reprinted in Manville Reporter, supra note 58, at 290 (Nov. 28, 1982).

212. Bankruptcy Code § 303(b)(1). Some future claimants also will be current claimants. They might assess their current claim in light of their future interest. But under the Code they still cannot trigger a reorganization unless the firm has a current cash flow problem.

213. Under the Code, the contingent claimant can, under no circumstances, trigger reorganization: “An involuntary case is commenced by the filing with the bankruptcy court of a petition . . . by . . . holder[s] of claim[s] against such person that [are] not contingent as to liability.” Bankruptcy Code § 303(b) (emphasis added). Equally important, an order for relief in an involuntary case will not be granted against the debtor unless the debtor “is generally not paying such debtor’s debts as [they] become due.” Id. § 303(b)(1). If contingent claimants are to be given an effective trigger, the happenstance of current debtor cash flow problems cannot be relied on. See infra notes 231–36 and accompanying text for suggestions for possible statutory reform.
they were permitted to do so whenever they could show a plausible claim, a nightmare of litigation might ensue. Bankruptcy proceedings could easily create many of the operational debilities that this Article’s approach is intended to resolve: diminished access to capital markets, a slow liquidation due to rapid maturing of claims, foregone business opportunities, an uncertainty in financial health that undermines relations with suppliers and customers, and misdirection of management effort. Even if some of these costs could be avoided, at least nuisance litigation could be expected to arise. Contingent claimants would weigh none of these costs to the firm in deciding whether to force a bankruptcy or wait for payment, other than perhaps to consider the possibility that bankruptcy would reduce the firm’s ability to pay the claim, and thus increase the chances of nonpayment. In principle, an occasional contingent claimant could “hold up” the firm for whatever it was willing to pay to avoid bankruptcy.

One might ask why the “hold up” problem is seemingly less severe in the case of contract or judgment creditors. The present Code does allow current creditors with very small claims to force a reorganization whenever the firm is unable to pay its debts as they come due. Not applying that standard to contingent tort claimants is justifiable in that their position differs in two respects from that of current claimants. First, of course, the Code requirement that creditors may not trigger reorganization unless the firm suffers from a current cash flow problem will not do for future tort claimants, since the congruence of current inability to pay with future inability, if any, is fortuitous. For the reorganization trigger to be effective for contingent tort claimants, they must be able to pull it not only when there is a current cash flow problem, but also and most crucially at times when cash flow for current claims is adequate. But to allow such a power without restriction could create problems concerning “hold ups” and excessively frequent involuntary tort-based bankruptcies.

214. See supra notes 27–46 and accompanying text.
215. Although the legal expense involved usually would present a practical barrier, see supra text following note 163, legal assistance occasionally might be furnished to a contingent claimant at a nominal or no cost—for example, by a relative. Such a claimant could create the “hold up” problem discussed in text. Even only a few such “hold ups” could be costly.
216. This power is given to current tort claimants as well as current contract creditors. Three noncontingent contract or tort claimants with aggregate claims of only $5000 can commence a chapter 11 proceeding. Bankruptcy Code § 303(b)(l).
217. Id. § 303(b)(l).
218. Manville Corporation, for example, had substantial cash on hand when it went into bankruptcy. See Maxwell, Manville’s Costs Could Reach $5 Billion In Asbestos Suits, Study It Ordered Shows, Wall. St. J., Sept. 15, 1982, at 4, col. 2. UNR Industries, was paying tort claims at a rate of $1 million per month in the year prior to its petitioning for bankruptcy. It had assets of $200 million. Manville and UNR House Hearings, supra note 19, at 103–04 (statement of Malcolm M. Gaynor, Esq., reorganization counsel to UNR Industries).
Second, the firm in principle can pay the current claimant to withdraw the bankruptcy petition. At least when the claim can be reduced to a liquidated sum certain, the firm would find it worthwhile to buy out the claim if the likely damage to the firm from reorganization exceeds the damage done by an immediate payout. In contrast, a single isolated contingent claim cannot easily be reduced to a specific dollar liability with certainty. Buy-outs to avoid bankruptcy then will be expensive, particularly if claimants make strategic demands for not just the expected value of their claims, but also for the value to the firm of avoiding the costs of bankruptcy.219

The risk of contingent claimants forcing an unwarranted reorganization, however, is small when aggregate contingent claims are large in relation to firm value. First, unwarranted bankruptcy costs are less likely. The firm in any case would incur the high "stress" costs caused by the unresolved overhang;220 the stress from the bankruptcy would only add incremental costs. Second, the costs, even if unwarranted, are borne by the tort claimants who take the firm in the reorganization.221 At the same time, when the aggregate contingent claims are high, stockholders and management become particularly poor choices for making the reorganization decision.222 Shareholders or managers may be scrambling to avoid reorganization.223

Thus one can say with some degree of confidence that as long as aggregate future claims are large in relation to firm value, early reorganization is better than risking the costs of delay. Future claimants ought to have the capacity to trigger a bankruptcy, as long as they can show that such circumstances exist. The other actors often will not seek reorganization, and the cloud of uncertainty over the firm's operations ought to be resolved. But implementation of such a standard would be difficult because the very questions to be answered are core issues in bankruptcy: What is firm value? What is the size of aggregate claims on the firm? Usually these questions are not fully answered until a plan is about to be confirmed and bankruptcy ended;

219. Currently disputed or otherwise unliquidated contract claims could also lead to this strategic "hold up" problem. The bankruptcy court, however, can assess their merits, in effect resolving the dispute and liquidating the claim for bankruptcy purposes. It then looks at the liquidated result to determine whether the prerequisites to an involuntary bankruptcy have been met. In re Dill, 30 Bankr. 546, 551 (Bankr. 9th Cir. 1983); In re Covey, 650 F.2d 877 (7th Cir. 1981); see also In re B.D. Int'l Discount Corp., 701 F.2d 1071, 1077 (2d Cir. 1983), cert. denied, 104 S. Ct. 108 (1983). In a mass disaster bankruptcy, resolution of the individual contingent claim is impossible. But the court could determine whether contingent future claims in the aggregate constitute a large portion of enterprise value and, if they do, proceed with the involuntary reorganization. That determination is the crucial condition to the statutory trigger for contingent claimants that I suggest should be put in place. See infra notes 231-36 and accompanying text.

220. See supra notes 27-46 and accompanying text.

221. Like the other interested parties, however, future tort claimants will make their reorganization decision in a socially warped fashion; they may be willing to substantially wreck the firm if they cannot obtain it in any other way.

222. See supra notes 188-204 and accompanying text. Contract creditors are no better decisionmakers. See supra notes 205-11 and accompanying text.

223. See supra notes 188-204 and accompanying text.
even then, they are usually only implicit in the plan’s negotiated result. Here, the basic issues of bankruptcy must be addressed before the process can begin.

Further difficulties can arise. To resolve preliminary questions of value, a hearing would be necessary. Yet Congress decided to eliminate valuation hearings from the current reorganization framework whenever possible. It established an elaborate bargaining model that is displaced by a valuation hearing only when the bargain fails. The standard that I have suggested would begin tort-based reorganizations with precisely the difficult determinations that Congress strained to avoid.

Yet it seems that that is what must be done. The toll should not be too high—only some reorganizations that might involve a large contingent tort liability would be affected. A standard requiring a showing of a high ratio of aggregate claims value to firm value would help deter any unwarranted petitions.

One could view these value determinations as preliminary in nature, subject to revision in subsequent hearings. That is, one could require a preliminary showing that future claims account for, say, 50% of the firm value. Presumably claimants would have to meet some burden of going forward by presenting evidence of such a large aggregate claims value. The debtor firm

224. Bankruptcy Code §§ 1125, 1126, 1129(a)(8), 1129(b) (bargained-for consent normally prerequisite to plan confirmation; valuation occurs only if consent not forthcoming from impaired classes).

225. Bankruptcy courts, however, may have to face these valuation difficulties regardless of whether the statutory reform that I propose, see infra notes 231–36 and accompanying text, is ever enacted. In the Manville reorganization, for example, the tort claimants have disputed the valuation of the expected tort claims, arguing that Manville's expected cash inflow will exceed expected tort claims in the ten years after the bankruptcy petition was filed, and that the matching of the expected inflow with expected claims indicates that the petition was filed in bad faith. Affidavit of Robert J. Rosenberg, at 3–5, In re Johns-Manville Corp. Nos. 82-B-11656/11676 (S.D.N.Y. Sept. 20, 1983) (counsel to the Committee of Asbestos Related Litigants), reprinted in Manville Reporter, supra note 58, at 1619–20 (Sept. 26, 1983). A condition to reorganization plan confirmation is that the plan be filed in good faith. Bankruptcy Code § 1129(a)(3). The Manville court seems to have viewed this good faith requirement as depending in part on the good faith filing of the petition. In deciding whether or not to dismiss the petition, the court made a preliminary estimate of the value of the tort claims. In re Johns-Manville Corp., 3 Bankr. L. Rep. (CCH) ¶ 69,615 (Bankr. S.D.N.Y. Jan. 23, 1984) (decision and order on motions to dismiss Manville's chapter 11 petition).

226. The problems potentially raised by giving future claimants the power to trigger reorganization also can be reduced somewhat by requiring the named petitioning future claimants to have probabilistic claims with a significant aggregate value, in contrast to the de minimis current claims standard.

227. Or, to account for contract and current creditors, one could require a showing that future claims account for 50% of net worth—net worth being calculated by subtracting from firm value the contract and current tort claims, but not aggregate future contingent claims. But see supra text following note 130 (suggesting reorganization can leave tort claims unaffected if they are small in relation to firm value; contract claimants can become the firm’s owners).

228. The wisdom of placing the initial burden on claimants is questionable, however. On the one hand, management usually has better information and therefore should bear the burden of producing it; on the other hand, we are trying here to limit unwarranted reorganizations and destroy the “hold-up” potential. One can only compromise these considerations; in the text I do so by using a shifting burden.
and its management, because of their superior access to information, then would have the burden of showing high firm value or low aggregate claims value. If management lost this initial hearing on the relationship between firm and claims value, but by the end of the reorganization process it showed that future claimants will only take 25% of the firm, there might seem to be little basis on which to dismiss the whole petition; the costs of reorganization—the principal basis for not allowing everyone to petition—will have been incurred already. But management is likely to have superior information about the firm’s probable future liability, and future tort claimants are likely to have an inferior litigation capacity. The judge therefore might be given authority to dismiss the proceeding or confirm the plan without necessarily wholly discharging the firm’s liability on the tort claims.229

6. Public Authorities. — Public authorities will not be subject to the same pressures from self-interest that make shareholders, management, contract creditors, and current tort claimants inadequate surrogates for future tort claimants, and that make future claimants all-too-ready to trigger bankruptcy. But public authorities also cannot be viewed as perfect decision-makers. Far from the scene, they lack much of the information necessary to make judgments on whether to pursue reorganization; the very existence of large future claim levels may not readily come to their attention. Furthermore, those agencies—such as the Food and Drug Administration or the Environmental Protection Agency—that are likely to have some information and expertise about the existence and probable damage from, say, a toxic tort, are not likely to be particularly astute in bankruptcy and financial matters. The converse is also true: those agencies, such as the Securities and Exchange

229. Bittner v. Borne Chem. Co., 691 F.2d 134 (3d Cir. 1982) (uncertain claims valued at zero, but firm not discharged on liability on claim), discussed supra note 145, gives some authority for this kind of flexibility under the current Code.

When the claims are expected to be low, the risk of firm debilitation discussed supra notes 27-46 and accompanying text will not be severe. Thus no accommodation between operational debilitation and uncertainty in distribution of value need be made.

A complete nondischarge of the tort claims could effectively make the tort claimants senior to unsecured contract creditors. The tort claimants would be paid in full as their claims came due; the other creditors would have been paid pro rata or on some consented-to scaling down of the claims during the reorganization, freeing the firm from liability on those claims. See supra note 123 (discussing unfair discrimination and the legislative history on contract claims). The point here is not so much that the court should not as a distributional matter discharge the tort claims, but that when those claims are small in relation to firm value, the bankruptcy principle of debtor rehabilitation does not require that anything be done with the tort claimants. Furthermore, the size of claims in relation to firm value has constitutional implications. In Part III, I suggested that so long as tort claims are large in relation to firm value, the notion that due process requires that no formal action can be taken on contingent claimants until they are notified of the bankruptcy proceeding ignores reality. Every time the firm acts, it affects the value of the contingent claims. See supra text following note 171. That counterargument to a constitutional requirement of notice, however, is irrelevant when claims are small in relation to firm value. See id. For discussion of the relationship between tort claimants and secured creditors, see Schwartz, supra note 49.
Commission or, perhaps, the Justice Department, that have financial expertise are likely to lack scientific ability. Interagency coordination might be necessary, increasing the chances of inaction or mistake.

Pressure exerted on Congress by interests that would be threatened by public agency intervention could overwhelm the weak pressure from unorganized future tort claimants. Lobbying thus may prevent a legislative grant of power to public authorities, or deny funding adequate to investigate and act. Additionally, the public agency with power and funding may respond to populist impulses by intervening in instances when unwarranted or by intervening only in highly publicized cases that provide political benefits.

Since public authorities might not commence tort-based bankruptcy proceedings that would be socially beneficial, Congress should seek to fashion a triggering mechanism for other actors. Nevertheless, if underintervention were the only potential drawback, adding an agency's finger to the trigger would not be deleterious. The risk of overintervention, which seems equally plausible, could be mitigated by subjecting public agencies to a requirement similar to the standard suggested earlier for reorganizations triggered by contingent tort claimants: that they convince the court that contingent claims are large in relation to firm value.229

B. A New Statutory Framework for Contingent Tort Claims

A central problem with the present statutory framework is that it must be interpreted to allow all future claims or none. That is, either the Code's definition of "creditor" excludes those with contingent tort claims entirely, or it includes every such claimant.231 A better approach would be to permit a court to consider the range of uncertainty, its consequences and the likely informational bias of the party seeking reorganization, and then decide whether to proceed. When aggregate tort claims dwarf other claims and interests, an immediate reorganization is desirable. When tort claims seem unlikely to dwarf others, but their relative size could vary greatly—and a

229. The history of Securities and Exchange Commission (SEC) involvement in chapter X reorganizations and the history of derivative suit litigation makes one suspicious that neither public authorities nor private enforcement would trigger reorganization whenever ideally warranted. See Coffee & Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261, 316, 318-20 (1981); cf. R. Clark, supra note 122, §§ 754, 754.1 (examples of appointment by public authorities of corporate receivers); Blum, supra note 51 (criticizing SEC's application of corporate reorganization doctrine); Note, Inflation and the Concept of Reorganization Value, 34 Vand. L. Rev. 1777 (1981) (criticizing SEC valuation of bankrupt firms). The question, however, is not whether they would serve the role well in the abstract, but whether the alternatives are worse.

231. See supra notes 136-61 and accompanying text. But see Bankruptcy Code § 1129(a)(3) (good faith prerequisite to plan confirmation); supra note 145 (case law arguably provides flexibility in such instances). An expansive interpretation of the Code's good faith provision could deny plan confirmation if the plan would provide little value for tort claims that were of highly uncertain future value. See infra note 234 (fourth paragraph).
narrow range of values is unlikely—the judge should be permitted to weigh the costs and benefits of confirming a plan for an immediate reorganization. The court then could delay reorganization, confirm the reorganization plan, or confirm the plan but deny a discharge in whole or in part on the tort claims. The current statutory framework does not contemplate that range of choice.

Although the results might be far-reaching, the statutory tinkering required would be minimal. Section 1129 of the Bankruptcy Code, which establishes conditions for plan confirmation, would be amended as follows to stymie insider attempts at reorganization if future claims are uncertain in size but are ultimately determined to be small in relation to firm value:

(a) The court shall confirm a plan only if all of the following requirements are met: . . .

(12) There is no reasonable possibility that the value of aggregate contingent claims will significantly exceed the value of the compensation to be paid future claimants under the plan, unless under the plan:

(A) the future claimants take value exceeding 50% of the firm's value (calculated without regard to the value of any claim on the firm); or

(B) the debtor is shown to be highly likely to have its operations severely compromised absent plan confirmation and adequate provision is made (via insurance, a reserve fund, or partial or full nondischarge, or otherwise) for reasonably possible contingent tort claims; or

(C) there is no reasonable possibility that under the plan the contingent tort claimants will receive less than their probabalistic pro rata share pursuant to Section 1129(b).

232. Alternatives sketched earlier would include a “purgatory” freeze on distributions while the firm operated in bankruptcy, see text accompanying notes 114–22, or a going concern liquidation with the cash proceeds preserved until the proper distributional result became more certain, see supra note 63.

233. To the extent that statutory changes are needed to implement the claims-pooling approach, some might argue that this need implies a construction of the Code that bars future tort claims from early reorganizations. This line of argument does not seem especially fruitful, however. Whether the Code is interpreted to necessarily gather all future claimants into a reorganization or to bar them completely, the result will be unsatisfactory. This either/or choice simply requires a decision on which of the two imperfect results is more satisfactory.

234. If the firm is worth $2 billion and expected claims of $2 billion have a 25% chance of occurring, the claims' expected value would be $0.5 billion. The first clause therefore would prevent the confirmation of a plan discharging the debtor from tort claims. Either a majority of the firm value would have to be set aside for them, or insurance, a reserve fund, or nondischarge would have to be provided, along with a showing of probable operational debility. A pro rata scaling down of the tort claims could take place only if the judge were very sure that valuation was accurate.

The 50% figure in the first clause is chosen somewhat arbitrarily to serve two purposes. First, it provides a level at which the reorganization is presumptively unlikely to divert significant value
The Code's requirement that there be a current cash flow problem for involuntary reorganizations would have to be eliminated if the contingent tort claimants or public authorities are to be permitted a role in triggering reorganization. 235 But, as already noted, to do so could create "hold up" and nuisance litigation problems. The appropriate compromise would seem to be to

from tort claimants. Since they would then be taking most of the value that the firm can provide, a mistaken distribution could not damage them significantly. Second, it serves as the threshold portion of enterprise value that tort claimants must show they account for before they can trigger the reorganization. See supra notes 219-26 and infra note 236 and accompanying text. This figure should be based on an estimate of what claims level would probably throw the firm into financial stress. Note here that the average contract debt level of public firms usually has not been much more than 30% of the firm's market value. Gordon & Malkiel, Corporation Finance, in How Taxes Affect Economic Behavior 131, 158 (1981). This statistic might justifiably choosing a lower percentage for the tort claimants' trigger.

This proposed statutory amendment does not explicitly account for the possibility that management would attempt a reorganization when it has superior information on the firm's likely future liability, which they expect to be large, but on which others are misinformed or uninformed. This possibility is not an easy one to account for, other than as suggested in text. That is, either the claimants must receive most of the firm's value, they must be provided with insurance or not be discharged, or the judge must have few residual doubts about the risk of undercompensating tort claimants.

As noted, the current Code denies a court authority to confirm a plan of reorganization if, inter alia, "[t]he plan has [not] been proposed in good faith . . . ." Bankruptcy Code § 1129(a)(3). Some have suggested that the bankruptcy courts' equitable power extends to dismissing bankruptcy petitions not made in good faith. Gaffney, Bankruptcy Petitions Filed in Bad Faith: What Actions Can Creditor's Counsel Take?, 12 U.C.C. J.L. 205, 210-11 (1980). An expansive judicial interpretation of the good faith requirement could require insiders, if they are the plan proponents, to make an affirmative showing that there is no substantial chance that future claims are significantly undercompensated in proportion to other claims.

This Section is not intended to detail all of the necessary statutory changes. For example, definitions of future claims and expected future claims would be needed. The requirement that future claims be reduced to a sum certain, Bankruptcy Code § 502(g), would have to be restructured. Some clarification that contingent tort claims could be asserted in a reorganization might be worthwhile. See Bankruptcy Code § 101(5); supra notes 139-61 and accompanying text. Mechanisms would also be necessary to guard against collusive filing by the firm and some friendly contingent claimants aiming to reduce claims to an artificially low value. But the proposals outlined here give an idea of the basic changes necessary.

235. The relevant portion of the Code now reads:

An involuntary case is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title—(1) by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or an indenture trustee representing such a holder, if such claims aggregate at least $5,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims . . . .

Bankruptcy Code § 303(b).

It would be amended by adding a new subsection to provide that an involuntary petition may also be filed

by three or more contingent claimants, or by certain public authorities on behalf of such claimants, if their claims aggregate at least $100,000 in present value after giving due effect to the probability of the occurrence or not of such contingency or contingencies.

Permitting future claimants to file a bankruptcy petition under the Code, however, will not permit them to obtain any relief, since Bankruptcy Code § 303(b) requires a cash flow crunch as a prerequisite to relief. See infra note 236.
permit a court to grant an order for relief only when the total contingent claims are shown to be large in relation to firm value.\footnote{236}

CONCLUSION

The basic bankruptcy principle of debtor rehabilitation in the abstract requires some resolution in bankruptcy of a firm's large contingent tort liability. When unresolved claims in the aggregate approach or exceed firm value, the firm often cannot be well-run and consequently cannot adequately compensate those claims. But this norm, which essentially seeks to encourage sound, efficient enterprise administration, may not seem amenable to practical implementation, if implementation must involve immediate, accurate compensation of future claims in the reorganization. Identification in an early reorganization of individual future claimants will be impossible. Accurate, immediate compensation will be difficult if the firm has an uncertain future value and if, as is likely in mass tort cases, future damages are highly uncertain as well.

\footnote{236. Thus Bankruptcy Code § 303(h) would be amended to provide in a new subsection (3): (h) If the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed. Otherwise, after trial, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed, only if— (1) the debtor is generally not paying such debtor's debts as such debts become due; or (2) within 120 days before the date of the filing of the petition a custodian . . . was appointed or took possession; or (3) in the case of a petition under Section 303(b)(3) (initiated by, or on behalf of, contingent claimants), the present expected value of aggregate future claims exceeds 50% of net firm value (i.e., operational value minus the value of contract and current tort claims) unless the expected value of aggregate future claims is less than 25% of the firm's operational value (i.e., determined without regard to the value of any claim on the firm).

I have tried here to sketch statutory amendments that would not differ radically from the Code's current structure. If one were not so constrained, a greater range of alternatives might be investigated. For example, one might require that an industrial firm carry tort insurance in an amount up to the firm's operational value. A decision on whether such a requirement would be wise would turn in part on a judgment about relative transaction costs. On one hand, a tort-based reorganization will be a messy matter with much waste and litigation, no matter how clear the statutory standards are made. On the other hand, a blanket insurance requirement would compel many firms without meaningful tort risks to incur unnecessary insurance costs. Or viewed another way, many firms that would otherwise self-insure could not do so, even though their owners are prepared to bear the risk of tort disaster. Moral hazard problems would also arise.

Mandated insurance would raise other bankruptcy questions. For example, if a firm were to obtain tort insurance covering liability up to the firm's value, and its actual liability were then to exceed that amount, could the tort victims make claims on the insurance and then against the firm? If so, the bankruptcy problem of a mass tort disaster would still arise, albeit less often.

Tort claims could be given priority over all contract claims in reorganization. Priority would alleviate some of the uncertainty in distributions and would induce some creditors to insist that the firm carry tort insurance, as long as the creditors were unwilling themselves to bear the risk of disaster. This shift to creditors of more of the risk of a tort disaster would thus entail the transaction costs of occasional further risk assessment by creditors and additional insurance transactions.
But neither current individual identification nor current individualized compensation is a necessary prerequisite to early reorganization. Claims can be pooled and centrally administered in a manner analogous to the central administration by trustees of bond indentures or pension funds. Compensation methods similar to the variable annuity would reduce disparity in compensation among the future tort claimants.

One important level of uncertainty, however, would remain: the uncertainty of whether future tort claimants in the aggregate will take an accurate proportion of the firm. Given their—or their representative’s—informational and other inadequacies, the assigned value of future claims is likely to be systematically underestimated. But paradoxical as it may seem, the more substantial the tort disaster, the easier the resolution of this problem will be. That is, as long as the value of the future tort claims is large in relation to firm value, as well as to the value of contract claims, there is only a small risk that the contingent tort claimants will be undercompensated, or that the other claimants and stockholders will be miscompensated. Tort claimants will receive most of the firm’s value in any case. Statutory reform would be needed to deal properly with the situation in which the tort disaster is relatively small and the value of future claims therefore is considerably less than firm value or the aggregate value of other claims. The courts should be given the authority to require the reorganization plan to provide for the possibility that future claims will turn out to have a value much greater than the expected, probabilistic value assessed during the course of the reorganization.

The Code and due process norms present ambiguities, but they seem resolvable. Since Congress intended bankruptcy to resolve a large aggregate liability, an infelicitous and ambiguous statutory definition of “creditor” should not bar an approach premised on basic bankruptcy policy. If courts continue to interpret the Code to bar early reorganization, legislative revision should be undertaken to clarify the Code’s implementation of fundamental bankruptcy goals. Due process considerations are perhaps relevant to the determination of liability and damages in individual cases, but their importance in reallocating the enterprise’s total value—most particularly when the allocation sets aside most or all of the firm’s value for the future tort claimants—is quite weak.

Although early resolution of large aggregate future claims follows from core bankruptcy norms and is administrable through a pooling mechanism, the possibility of strategic reaction outside of bankruptcy—that interested parties may impede reorganization or trigger it when inappropriate—must be considered. Most centrally, a mechanism for triggering reorganization must be fashioned. Stockholders and management often will want to avoid bankruptcy, even if the best operation of the enterprise requires early reorganization. Reorganization could eliminate shareholders entirely, and might lead to management’s ouster.

Contract creditors and current tort claimants are poor surrogates for future claimants. First, current claimants often would prefer a delayed reorganization, since their claims can be paid in full, without sharing with future victims. Second, long-term contract creditors bargain prior to giving value to
the firm for covenants that enable them to force a reorganization at critical moments. But they also would often prefer receiving interim payments through delay to an early reorganization.

Future tort claimants, however, can neither trigger reorganization under the current Code nor bargain for covenants to force reorganization at crucial times. Thus, amending the Code to give them some power to initiate reorganization is appropriate. Yet giving contingent claimants a finger on the reorganization trigger would raise other serious problems. The possibility of unnecessary bankruptcies when only a few risks have arisen, and of simple but potentially pervasive nuisance litigation, both would have to be controlled. The best way of doing so—although an imperfect one—would be to amend the Code, first, to permit contingent tort claimants to initiate reorganization but only upon a preliminary showing of a large ratio of aggregate claims value to firm value before the bankruptcy may proceed and, second, to allow some public agencies to petition for reorganization, but require them to make the same showing.

Whether or not bankruptcy institutions like it, mass tort disasters have now become bankruptcy problems. A refusal to take action will itself be a bankruptcy decision having serious consequences. Yet the uncertainties and difficulties involved in these problems ought not to be underestimated. Their resolution will require that the imaginations of both the legislature and the judiciary turn to those mechanisms that can accommodate these difficulties and to the construction of new devices to fill in the gaps. A complete bankruptcy solution to the mass tort problem will be difficult to achieve, but much of practical value can be done.