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## Commercial Law and the Public Interest

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## COMMERCIAL LAW AND THE PUBLIC INTEREST

*Jay Lawrence Westbrook\**

In commercial law policy debates in the United States, the consideration of public interests has been muted. The success of “contractualist” ideas (along with “public choice” theory) has forced to the background notions of broader social interests and the significant secondary effects of commercial law rules, leaving the policy debates focused largely on competing claims of efficiency and injustice to the immediate parties to an activity or transaction. In this essay, I want to explore this phenomenon in a preliminary way. My long-term objective is to understand the reasons for this move away from considerations of public interests and perhaps to find a way to return those interests to their proper place.

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\* Benno Schmidt Chair of Business Law, The University of Texas School of Law. I am grateful to Patrick Wolfgang, Texas ‘15, and William Langley and Kelsi Stayart, Texas ‘16, for their help in research for my public-interest project, starting with this article. This paper was delivered in the summer of 2014. While its principal points continue to reflect my views and the nature of my current academic project, those views and the world have moved on in some respects. In particular, I have become more careful to say “public interests” (plural). I also note that the American Bankruptcy Institute Commission has now delivered recommendations about bankruptcy reform that provide a rich medium for critiques based on public interests. See AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11 (2014).

How did the notion of a public interest in commercial law questions get elbowed aside when it had long been a staple of American academic and political discourse? The primary reason has been the rise of “public choice” theories<sup>1</sup> and “contractualism.”<sup>2</sup> This essay focuses on the contractualists as its primary example. For the most part, the contractualists are content to identify one public interest—freedom of contract in a free market—as the singular public interest to be served in commercial law, primarily on the basis of efficiency.

One of the reasons that other public interest considerations have been elbowed aside is that those who are concerned with public interest factors do not have a church as do the public choice and contractualist scholars. That is, these scholars have a set of institutions—conferences, centers, and the like—and a common set of intellectual “moves” and terminology combined with a deep sense that their approach is almost always the best approach to any legal policy question.

In my field of insolvency, Professor Douglas Baird has attempted a distinction between “proceduralists” and “traditionalists” to mark these scholars from the rest,<sup>3</sup> but the labels are not very helpful and the foundation for them is weak. I think it is more useful to focus on the contractualists versus the “regulators” (both of which are defined below).

I try in this essay to explain how and why public interests have been ignored. The essay form permits suggestion and speculation to substitute for precision and detailed references in these early stages of my developing project. Many points are uncertain at this stage. I am unclear, for example, whether the relative decline of arguments about

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<sup>1</sup> See, e.g., JAMES M. BUCHANAN, PUBLIC CHOICE: THE ORIGINS AND DEVELOPMENT OF A RESEARCH PROGRAM (2003).

<sup>2</sup> See, e.g., ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, KATHERINE PORTER & JOHN POTTOW, THE LAW OF DEBTORS AND CREDITORS (7th ed. 2014) [hereinafter DEBTORS AND CREDITORS].

<sup>3</sup> See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576-77 (1998). For a critique of his position, see Jay Lawrence Westbrook, *Empirical Research in Consumer Bankruptcy*, 80 TEX. L. REV. 2123 (2002).

the public interest is primarily an American phenomenon or one found in many parts of the academic world.

The most challenging element in the analysis is the definition of the public interest as distinct from an individual or aggregate interest. An example may help at the start. In debates about the enforcement of form (boilerplate) contracts against consumers, those favoring enforcement generally speak of freedom of contract in a market society and rely on the consumer's consent as the central reason for enforcement. Those who would limit enforcement generally argue (a) that the consumer does not really consent in a meaningful sense; and (b) that, even with consent, enforcement of some or all of the form provisions would be unjust or unfair to the consumer party.

The arguments on each side have considerable power, but my point here is that each argument is rights-based—that is, limited to the rights of one of the parties to the contract. The arguments may apply to many sellers that issue form contracts and to millions of consumers against whom they might be enforced, but this aggregation of instances does not amount to an argument about the public interest. No doubt the sellers' advocates would claim that society generally is benefitted by enforcement, and the consumers' champions would make the same claim about nonenforcement, but each would be speaking of the aggregation of individual results, not a distinct collective interest that should be included in determining an appropriate legal policy.

By contrast, other sorts of arguments—whether good or bad on the merits—would be based on a notion of the public interest. As a first approximation, a public interest may be defined as a concern about the positive and negative effects of a policy on most of the people in society, including those whose individual interests are not directly implicated by a given transaction or activity. In our pending example, the public interest in boilerplate might include factors different from freedom of contract or an unjust result for the consumer party.

There are a number of public interest concerns in the context of form contracts. One category might be called “secondary effects.” Consider the consumer advocate's argument that courts or regulators should be more ready than they have been to strike down unreasonable and oppressive contract terms. One aspect of that claim would be the

benefit to the consumers thus spared from enforcement of those terms. But another would be the assertion that judicial activism would serve the public interest by arming the sellers' lawyers with tools to convince their clients to draft form contracts with a more even hand. That result might benefit society generally by giving everyone more confidence in entering into form contracts and creating a pervasive sense of fairness in the market place. This sort of argument differs from the individual rights argument because it rests upon costs and benefits to society generally rather than arguments about "true" consent or normative beliefs about fairness. This sort of argument is also less subject to claims of individual consent or waiver. My sense is that this sort of shift in the focus of the argument would be important, albeit sometimes subtle in the abstract.<sup>4</sup>

For the purposes of this paper, I have no interest in how these arguments come out or in the numerous counter and counter-counter arguments that would arise. The necessary point is that there may be a public interest to be identified and that interest may have a significant influence on the nature and direction of the debate. It can have that effect even though it must be conceded that the importance of the distinction is sometimes masked by the difficulty in making it. It must also be conceded that aggregate and public interest benefits/harms may overlap considerably, but that ambiguity does not necessarily make the public interest less salient.

#### I. THE DISAPPEARANCE OF THE PUBLIC INTEREST

In recent years, discourse in many legal fields has been "privatized" by the assumption that the stakes—the benefits and costs—at play in a given activity are limited to the private parties who are individually interested in possible outcomes. Commercial scholars are prominent among those committed to this view. Such scholars are

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<sup>4</sup> These sorts of arguments are often about "externalities," positive or negative, that are recognized in principal in contractualist presentations, but are often omitted or subordinated. Externalities sometimes effect only a certain group of people and therefore are not public interest questions in the sense that I am using the phrase. But a fair number of public interest arguments are about ignored externalities.

generally found among those who embrace “public choice” theory and among those whom I have characterized as “contractualists.”<sup>5</sup>

Loosely speaking, scholars who embrace the “public choice” theory might claim that there is rarely such a thing as a public interest that is relevant to a legal issue, only an aggregation of private ones that become expressed in law largely as a matter of interest group wins, losses, or compromises.

Next door live the contractualists, who believe that commercial policies are best understood as a series of contracts, rather than sovereign commands. For them, the ideal society consists of a web of contracts freely adopted by each person. (Locke meets the Uniform Commercial Code.) Because public law is sometimes a practical necessity, that law should be defined by the results that private contracts would produce if they were feasible. The contractualists are in turn divided between those who view the contractual approach as a useful metaphor for determining the correct legal result and others who argue for commercial laws that facilitate actual bargains that would replace substantive legislative rules to the maximum extent, often by enabling the legal contortions necessary to attempt to avoid the problem of third-party effects. Each of these views privatizes legal thought by banishing traditional notions of a societal or collective interest. Their opponents I will call the “regulators”: scholars who are more sympathetic to mandatory legal rules and government regulation in the public interest.

Both public choice and contractualism are closely related to neoclassical economic theory and to the Law and Economics “movement” in the U.S. and elsewhere, with its emphasis on increasing efficiency in the generation of wealth and its disinterest in questions of wealth distribution. They also parallel a reductionism in political science, where the literature has been dominated by interest group influence and legislator self-interest, rather than the actors’ beliefs and perceptions about the public interest. In recent years, this approach has been extended to scholarship about judges, seeking patterns of decision-making related to political affiliations and personal

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<sup>5</sup> See Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1199 (2005); DEBTORS AND CREDITORS, *supra* note 2.

backgrounds. Much of this scholarship is useful, but like the rhododendron it has too often exterminated valuable competitors.

These and other factors have contributed to a focus on individual rights and obligations and thus on individual benefits and harms. This focus has had a major impact on policy debates. American examples of affected policy issues include the existence *vel non* of private rights of action based on statutory provisions that do not explicitly grant such rights; the nature of fiduciary and other management duties owed to investors and creditors in corporate law; the proper scope of arbitration clauses in both consumer and international commercial arbitration; and the emergence of secured creditor domination of the reorganization of distressed businesses. In this essay, I want to address just the last one as an illustration.

## II. AN EXAMPLE: THE PUBLIC INTEREST IN REORGANIZATION CASES

Chapter 11 reorganization lies at the heart of United States insolvency law, and it is the primary feature of our law that has influenced legal reformers all over the world. Yet it seems to me that some of the central policies that drove its adoption in the United States and its influence elsewhere in the world have become obscured in modern scholarship. Obviously, the achievement of a law's goal should be the touchstone for every aspect of its implementation, yet often in the United States goals are merely assumed and these assumptions often change *sub silencio*. For example, there is considerable discussion currently about the control of Chapter 11 proceedings by secured creditors, but relatively little attention to the goals of Chapter 11 in relation to control rights. Because secured creditor control effectively converts Chapter 11 to a vehicle for a version of contractualism, it is congenial to that school but unattractive to those who see a larger role for protective rules in the Bankruptcy Code. The correct result of the contention between them ultimately turns on convictions about the proper goals for reorganization law.

I do not attempt here to make the case for or against creditor control or to answer the larger predicate question, which is the purpose of reorganization procedures. Instead I want to put on the table some of the public interest issues that should be part of those discussions.

It is striking that the debate has become almost entirely rights based, ignoring any suggestion of public interests in the outcome, just as with the form consumer contract example discussed earlier. The debate has been conducted by scholars committed to a private-sector, free-market view versus those more concerned with normative values like protecting weak parties and nonparticipating parties. As with form contracts, the lack of apparent concern with a public interest is often found on both sides.<sup>6</sup>

Most of the scholars who favor secured creditor control are contractualists or quasi-contractualists. Dean Robert Rasmussen is a pure contractualist who would use a company's articles of incorporation as a standard contract with creditors:

When a firm is formed, it would be required to select what courses of action it wishes to have available if it runs into financial difficulties down the road. . . . By offering a discrete set of choices, the menu would enable banks and other creditors to anticipate the interest-rate adjustments that would be made for each option. They could then communicate to those establishing the firm the true cost of selecting one bankruptcy provision over another.<sup>7</sup>

His fellow contractualists propose various other techniques for producing contractual agreement, but all support their position with arguments that rest on benefits to the individual firms as debtors or creditors and consider any possible harms in the same way. Underlying their approach is only one contention that could be read as invoking the public interest. Professor Lynn LoPucki, a frequent opponent of the contractualists, summarizes that argument as follows:

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<sup>6</sup> A nice example of the absence of the public interest argument is found in the Detroit bankruptcy where little of the legal debate seems to have addressed the public interest benefits arising from the availability to the public of a remarkable collection of art at very low cost. Yet that interest had a major impact on the results of the case. See Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. (forthcoming 2016) (importance to the public of preservation of art museum).

<sup>7</sup> Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 66-67 (1992).

The case for freedom of contract rests squarely on the assumption that each party chooses the contract because the contract makes that party better off. Because each party is better off, all parties are better off in the aggregate. That aggregate then becomes a proxy for “social welfare.” In the bankruptcy context, this theory holds that thousands of correct decisions by a debtor and each of its creditors and shareholders will generate one correct decision—the bankruptcy contract—in the aggregate. That decision will maximize social welfare.<sup>8</sup>

Other contractualists hedge their commitment to contract a bit more than Dean Rasmussen, but their caveats serve to emphasize their concern with individual rights and obligations. Thus Professor Steven Schwarcz limits enforceability of contract deviations from the “default” rules of the Bankruptcy Code to those that do not offend the principle of equality of distribution nor create an externality that would be unenforceable as a matter of contract law.<sup>9</sup> The former limit is protective of the rights of claimants in a specific case, while the latter amounts to a public policy exception, something rarely found in American contract law and quite different from the broader and much more common instance of a relevant public interest.

Only one contractualist article has seemed to me to rely importantly on a public interest other than the general ground of freedom of contract. It was written by Professor Alan Schwartz who supported a contractualist approach with the claim that it would further the only legitimate goal of reorganization, which for him is generation of the lowest possible interest rate on debt capital.<sup>10</sup> Whatever the merits of that interesting assertion, it does make a claim about a public interest. It is probably significant that no other contractualist scholar has taken up that argument.

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<sup>8</sup> Lynn LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317, 341 (1999).

<sup>9</sup> Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 542-44 (1999).

<sup>10</sup> Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 343 (1999).

What is more surprising is that fairly often scholars who are regulators also focus on private concerns rather than public ones. For example, I wrote an article directly attacking the contractualist position on secured creditor control of reorganization, but devoted it almost entirely to the negative effects of that approach on the maximization of value and fair distribution to the claimants rather than any considerations beyond those immediate parties.<sup>11</sup> Elizabeth Warren and I launched a direct attack on the contractualists based on empirical data, but the entire thrust of the article was that a contractualist approach would result in disadvantage to various parties to a reorganization proceeding.<sup>12</sup> The principal exception was a small section dealing with transaction costs, and even that had a focus on the contracting parties rather than society in general.

Only two major articles on the rule maker side in the debates about bankruptcy seem to have squarely addressed an alleged public interest. Professor Susan Block-Lieb pointed to the adoption of various statutes regarding pensions and retiree benefits as establishing a public interest that should have weight in making bankruptcy policy.<sup>13</sup> She insisted that Congressional action to support pension benefits represented a Congressional determination that pension protection was a general interest of our society and therefore required the consideration of that public interest in forming bankruptcy policy.

Her discussion illustrated an important aspect of the conflict between party-oriented arguments and public interest arguments. She explicitly rejected the standard contractualist argument that substantive public policy should have no place in bankruptcy, viz any concerns about pensions must be cabined in pension law discussions, concerns about financial speculation must be resolved in legislation directed at financial speculation, and so on. The effect is to prevent many public interest factors from being given weight in making bankruptcy law. The compartmentalization of legal policy contributes substantially to a focus on the interests of the immediate parties to a particular economic relationship and away from a more general social or economic

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<sup>11</sup> See Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 837-52 (2004).

<sup>12</sup> See Warren & Westbrook, *supra* note 5.

<sup>13</sup> See Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503 (2001).

perspective. By taking on the argument against policy balkanization, Professor Block-Lieb staked out a position for substantive public interests in bankruptcy policy.

The second major article pointing out public interest considerations in reorganization policy was written by Professor (now Senator) Elizabeth Warren. In an article responding to the contractualist approach, Professor Warren listed the goals of bankruptcy as follows:

*Enhance Value.* By creating specialized collection rules to govern in the case of multiple default and by requiring collective rather than individual action, the value to be gleaned from the failing business can be increased while the expenses of collecting that value are decreased. Bankruptcy rules can also preserve going concern value while they can cabin many forms of strategic behavior that would otherwise waste collective resources.

*Establish an Orderly Distribution Scheme.* By moving away from the race of the diligent at state law, there can be a considered judgment of who should receive preferences in the event that not all parties' expectations can be met. Distributions to parties with different legal rights can be settled in a legislative arena. Parties with no formal rights to the assets of the business, such as employees who will lose jobs and taxing authorities that will lose ratable property, may profit from a second chance at restructuring debt and giving the business a chance to survive in situ.

*Internalize the Costs of Default.* A viable Chapter 11 system reduces the pressure on the government to bail out failing companies, thus forcing creditors to make market-based lending decisions and to monitor their debtors more closely.

*Establish a Privately Monitored System.* The initiation decision in bankruptcy is one of the hardest. A system that provides sufficient incentives for debtors to choose bankruptcy voluntarily or for creditors to force their debtors into it avoids the high costs that come with a publicly monitored system, both in terms of the costs of errors (decisions to place a company in bankruptcy that come too quickly or

too slowly) and the costs of monitoring. Such a system also avoids the potential politicization of such decisions.<sup>14</sup>

I have underlined portions of this list that reflect public interest factors. It is important to note that Warren was not often able to cite specific provisions protecting such values. Public interest factors are often hard to tie to particular legal rules. In effect, legislators rely on the courts to have those factors in mind, along with the structure of a statutory system as a whole, when construing a rule.

Generally, however, the debates about secured creditor control of reorganization and its relation to reorganization goals have settled into a rights argument with little attention to public interest factors. That is so despite the fact that the discussions surrounding the proposal and adoption of the Bankruptcy Code in 1978 were filled with public interest factors supporting reorganization. Jobs, community stability, and a second chance for company owners were high on the legislators' lists of statutory goals. For example:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's financings so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.<sup>15</sup>

Taking the preservation of jobs as an example, there is evidence that public officials continue to be deeply concerned with the preservation of jobs, but jobs have virtually disappeared from the reorganization conversation in the United States.

This point is illustrated when competing reorganization plans are presented to the courts. Under some circumstances, the Bankruptcy Code permits more than one reorganization plan to be submitted to creditors. If the necessary majorities vote in favor of both plans, which sometimes happens, the court must decide which plan to

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<sup>14</sup> See Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 344-76 (1993) (emphasis added).

<sup>15</sup> H.R. Rep. No. 95-595, at 220 (1977).

adopt. There is no statutory standard for making that choice, so the courts are free to consult such policy grounds as they think relevant. In the reported decisions on this point, there is little sign that the better preservation of jobs is a legitimate tie-breaker, despite the legislative history and despite the professed concerns of nearly all our political leaders. The interests of communities are also ignored, despite widespread state-level legislation in the United States designed to protect communities against hostile takeovers.

In addition to jobs and community stability, both mentioned by Warren, there was in 1978 an underlying theme of helping equity owners as well. The new Chapter 11 arose from the old Chapter XI, which was designed to permit small business owners to keep their businesses alive through negotiating a payout plan with their creditors. Congress intended to extend this idea by permitting management of all businesses, large and small, to remain as the “Debtor in Possession.” Thus we have the view of Chapter 11 reflected in the United Kingdom terminology: “rescue” proceedings.<sup>16</sup> That view of reorganization is reflected in the legislative history quoted above and continued to be a part of the culture and folklore of the new Chapter 11 well into its first decade.

Given that history, it is far from evident that only bondholders and other creditors are entitled to consideration while shareholders are not. Yet at some point the focus of scholarship and practice narrowed to the interests of the immediate parties and their statutory entitlements. Although the abolition in 1978 of the “absolute priority” rule (which puts shareholders at the bottom of the priority waterfall) in its strictest form<sup>17</sup> was intended to permit more flexibility in protecting the interests of shareholders, a number of articles continued to call the rule “absolute” and to decry any departure from it, which in turn obscured the legislators’ evident interest in “rescue.”

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<sup>16</sup> See, e.g. Vanessa Finch, *Re-Invigorating Corporate Rescue*, 2003 J. BUS. L. 527, 536-39 (2003); see also Gabriel Moss, *Comparative Bankruptcy Cultures: Rescue or Liquidation? Comparison of Trends in National Law—England*, 23 BROOK. J. INT’L L. 115, 121 (1997).

<sup>17</sup> John D. Ayer, *Rethinking Absolute Priority After Ablers*, 87 MICH. L. REV. 963 (1989).

The issue is whether interest of specific owners in a specific publicly held company is worthy of consideration, especially if equity is “under water” or “out of the money.” The contractualists consider that equity investors at that point cease to be parties in any real sense because of the absolute priority rule. Thus, the law’s concern should be solely with the interests of those who remain in the hunt. But the public interest in ensuring that shareholder interests are appropriately considered remains an important one, beyond recoveries in particular cases. Is a quick exit for equity sound business policy, given the importance of equity investing in the capital markets? That sort of public interest should be considered in deciding, for example, whether case law should give shareholders more protection against undervaluation of their company and other financial maneuvers. Little evidence can be found of an appreciation that there may be a public interest in the resolution of that question.

The lack of consideration of a possible public interest in these decisions—a public interest in jobs, in community stability, and in promoting and protecting equity interests—seems especially anomalous because they played an important part in the adoption of the most important single reform in the 1978 Code. That reform replaced a trustee in bankruptcy with a Debtor-in-Possession (“DIP”), conferring extraordinary power and flexibility on the managements of distressed businesses in Chapter 11.<sup>18</sup> Yet the notion of protecting owners of companies provided important support for that reform. If they are now replaced by an assumption, often explicit, that only the interests of creditors are important, and that the maximization of value for creditors is the only aim of bankruptcy law, then the idea of putting old management in charge of a company’s Chapter 11 case needs comprehensive review. Indeed, because nowadays the result is often to put a secured creditor in control despite its conflict of interest with the rest of the creditors, the DIP concept seems ripe for revisiting.<sup>19</sup> It is in consideration of the public interest in protecting equity investors that puts that question on the table.

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<sup>18</sup> 11 U.S.C. §1107.

<sup>19</sup> See generally A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875 (2009).

## III. A POSSIBLE RESPONSE

The nature and weight of these public interest factors in the evolution of reorganization is a long discussion far beyond the boundaries of this essay. What I do want to suggest are possible reasons for the lack of concern for the role of the public interest in commercial law debates. No doubt part of the answer is political. Regulation is not popular in the abstract, despite the recent reminders of the effects of deregulation provided by the Great Recession. But another reason for this lack of concern is that the regulators in academia have been too long on the defensive and have had too little new to offer. The contractualists have proclaimed “The End of Bankruptcy”<sup>20</sup> (via secured creditor control, which they embrace) and devised ever more clever and intricate ways for contract to replace legal provisions. All these have provided much fuel for academic reflection, tinkering, and debate. The regulators have been “traditionalists” defending the eroding status quo. Professors Warren and Block-Lieb published their public interest articles a decade ago, but little new has been done to explain or vindicate the interests they identified. Although the contractualists have largely run out of intellectual steam themselves, until the regulators resume a positive reform agenda at the conceptual level the public interest will remain behind the door when bankruptcy policy is made. The same is true throughout commercial law.

One step that courts might be encouraged to take would be to try to identify (or encourage the parties to identify) any public interest factors in a commercial dispute. In an appropriate case, they could even invite governmental agencies or NGOs to submit views and arguments if those submissions would not unduly delay the case or increase the expense for the private parties. Pointing out those opportunities would be a major step forward in rediscovering the public interests we have somehow misplaced.

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<sup>20</sup> See Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 754-55 (2002) (describing a fundamental shift in Chapter 11 bankruptcy from a reorganization vehicle to a means of liquidation driven in large part by secured creditors who increasingly view the sales value of a firm’s current assets as greater than the going-concern value of those assets in the future).