Yale Journal on Regulation

Volume 29
Issue 1 *Yale Journal on Regulation*

Article 9

2012

Unlikely Bedfellows: The Coase Theorem, Bankruptcy Liquidations, and the Audubon String Quartet

Benjamin Zimmer

Unlikely Bedfellows: The Coase Theorem, Bankruptcy Liquidations, and the Audubon String Quartet

Benjamin Zimmer†

In 2001, the Audubon String Quartet expelled its first violinist, who then successfully sued the Quartet for more than $600,000. In the resulting bankruptcy proceedings, the musicians' instruments were liquidated to cover their debts. Classical musicians were outraged that the instruments were not covered under the "tools of the trade" exemption to bankruptcy liquidations. They prophesized the demise of one of the oldest American string quartets. Yet the Quartet regained its instruments and continued to operate for several years.

This Comment will explain how the Audubon's post-bankruptcy recovery of their instruments aligns with the behavior and outcomes predicted by the Coase Theorem. It will then show how the Audubon's ability to regain their instruments without access to the tools of the trade exemption undermines the assumptions underlying the exemption in the first place. The exemption's purported benefits are questionable, and it imposes new transaction costs that impede Coasian bargaining and harm borrowers and lenders alike.

Introduction

When the Audubon String Quartet played its final concert last August, it marked the end of a thirty-seven-year run for one of the United States' elite string quartets.[1] However, the event went largely unnoticed outside the classical music world.

---

† Yale Law School, J.D., 2012; Harvard College, A.B., 2007. The author would like to thank David Wishnick for his helpful feedback on early drafts of this Comment. He would also like to thank Allyson Bennett and the *Yale Journal on Regulation* edit team for their helpful suggestions in preparing this Comment for publication.

1. *See* Press Release, Audubon String Quartet, Audubon Quartet Announces Final Concert as an Ensemble (Apr. 11, 2011), *available at* www.audubon4tet.com/release.html (announcing that the Quartet would perform its last concert on August 8, 2011 because its members had decided to pursue other projects); *see also* Mike Allen, *Arts & Extras: Audubon Quartet To Go Four Separate Ways,*

Yet to anyone interested in bankruptcy law or law and economics, the quiet nature of the Quartet's dissolution should itself have been notable. Six years ago, the Audubon was grappling not with Beethoven, but with bankruptcy liquidation, and *The New York Times* and National Public Radio both reported on the Quartet's imminent involuntary demise. Yet in 2010, the Quartet was going on a national tour to celebrate its thirty-fifth anniversary.[2] The story of how the Audubon unexpectedly emerged from bankruptcy provides a powerful illustration of the applicability of the Coase Theorem to bankruptcies, with important implications for law.

This Comment will explore the previously unexamined law and economics of the Audubon String Quartet bankruptcy. It will focus specifically on the "tools of the trade" exemption at the heart of the Audubon case. This exemption precludes creditors from seizing "tools of the trade" in bankruptcy liquidations.[3] During the Audubon's bankruptcy, the Quartet and its allies argued vigorously that the exemption was insufficiently narrow because it did not cover their instruments. This Comment will argue that the Audubon's successful recovery of its instruments, in spite of losing this dispute, suggests the opposite. Not only does the tools of the trade exemption not need to be expanded; the Audubon's experience provides strong reason to question the exemption's existence in the first place.

The Comment will make this argument in three parts. First, it will explain the Audubon's bankruptcy and the Quartet's argument that the tools of the trade exemption should have been expanded to cover their case. Second, it will show how the Audubon's process of recovery aligns with the predictions of the Coase Theorem. It will further discuss how the applicability of the Coase Theorem to the Audubon's case undermines not only the musicians' specific arguments, but also the core assumption behind the tools of the trade exemption in general. Finally, the Comment will discuss the costs of the tools of the trade exemption and argue that, in light of the questionable assumptions underlying the exemption, those costs outweigh any benefits.

I. The Audubon Quartet Bankruptcy

To their listeners, string quartets are mediums of beauty and harmony. Internally, however, string quartets notoriously are anything but harmonious. As *Time Magazine* pithily put it, "one of the quickest ways to lose friends is to

---

ROANOKE TIMES (Va.), Apr. 26, 2011, http://www.roanoke.com/extra/arts/wb/284234 (announcing the Quartet's dissolution).

2. *See* Program Guide, Reston Comty. Ctr., The CenterStage Professional Touring Art Series, The Audubon Quartet in Their 35th Anniversary Season (Mar. 2010), *available at* http://www.restoncommunitycenter.com/images/CenterStage_Images/Audubon.pdf.

3. *See* 11 U.S.C. § 522(d)(6) (2006).

engage in the precarious art of chamber music."[4] In the winter of 1999-2000, such strife hit the Audubon Quartet. Due to interpersonal, musical, and organizational disagreements, three of the Quartet's members, including founder Clyde Thomas Shaw, sought to expel the first violinist David Ehrlich. Ehrlich filed a wrongful termination lawsuit against his former colleagues in Pennsylvania, where the Quartet was incorporated as a nonprofit.[5] Ehrlich argued that he was a minority shareholder in a closed corporation and that he had been unfairly "squeezed out" by the majority shareholders in violation of their fiduciary duties.[6] The Court of Common Pleas of Allegheny County agreed, holding "the treatment of Ehrlich to be oppressive."[7] The court ordered the other three members to pay damages related to his twenty-five-percent equity stake in the Quartet, his lost earnings, and his legal fees.[8] All told, this amounted to approximately $600,000.[9]

This liability proved too much for the Quartet to bear, and on December 12, 2001, the Quartet and its members filed for bankruptcy.[10] Bankruptcy, in turn, prompted a host of new legal issues for the Quartet. Most notably, the Quartet and the bankruptcy trustee contested whether the Quartet's members could keep their instruments, or whether they would be auctioned off and liquidated in order to cover their debts.[11] Section 522 of the Federal Bankruptcy Code allows debtors to exempt from liquidation certain classes of assets, including any "tools of the trade of the debtor" up to a certain value.[12] State laws include similar exemptions, and it is the debtor's choice whether to take the federal exemptions or the exemptions of the state in which the bankruptcy adjudication is proceeding.[13] The Quartet elected to take the state exemptions of Virginia, which has one of the most debtor-friendly caps for "tools of the trade" exemptions, allowing up to $10,000.[14] But even this generous cap came nowhere close to encompassing the Quartet's instruments, which were valued at more than $150,000.[15] The lawyer for Shaw and his wife, Doris Lederer

4. *Chamber Music: The Brothers Four*, TIME (May 6, 1966), http://www.time.com/time/magazine/article/0,9171,901862,00.html.

5. *See* Joel Rose, *Audubon String Quartet Lawsuit Mixes Music, Business*, NAT'L PUB. RADIO (Dec. 9, 2005), http://www.npr.org/templates/story/story.php?storyId=5046870.

6. Ehrlich v. Audubon Quartet, Inc., Case No. GD 00-9438 (Pa. Ct. Com. Pl. Oct. 12, 2001), *available at* http://mysite.verizon.net/renardym/paruling.pdf.

7. *Id.* at 12.

8. *Id.* at 13.

9. *Id.* at 12-13, 16.

10. *See In re* Wiencko, 275 B.R. 772, 775 (Bankr. W.D. Va. 2002).

11. *See* Lindsey Nair, *Judge Orders Liquidation of Members' Instruments*, ROANOKE TIMES (Va.), Dec. 14, 2005, http://www.roanoke.com/news/roanoke/wb/xp-44396.

12. 11 U.S.C. § 522(d)(6) (2006).

13. *See id.* § 522(b)(2)(A).

14. *See* VA. CODE ANN. § 34-26 (2011). The Federal Code, by way of comparison, allows less than $1000 for such exemptions. 11 U.S.C. § 522(d)(6) (2006); *see also In re* Patterson, 825 F.2d 1140, 1147 (7th Cir. 1987) (discussing the wide variation in states' caps and citing $10,000 as a generous cap).

15. *See* Nair, *supra* note 11.

(another member of the Quartet), argued that the musicians should nevertheless be able to keep their instruments. "'Tools of the trade' doesn't really describe what we're dealing with here," he argued.[16] The bankruptcy court, however, disagreed, calling the decision to liquidate the instruments a "no-brainer."[17]

The classical music world entered a state of despondency and outrage over the decision. Lederer cried outside of the courtroom. "I can't even imagine turning [my instrument] over," she lamented.[18] "It's just the judicial system gone awry," Shaw told *The New York Times*. "It's a horrible, horrible thing. Our instruments are our voices, our souls."[19] Shaw and Lederer were not alone in their despair. A public letter by nearly one hundred classical musicians called the liquidation of the instruments "devastating" and prophesized that the seizure would "effectively restrict[] the performing careers" of the musicians.[20] Even Ehrlich, under attack from the majority of his colleagues, became defensive about his decision to sue. "I would never have gone the distance if I did not believe very, very strongly that [my firing] was really outrageous," he told *The Times*. "I want to be whole again."[21] Joel Rose, covering the story for National Public Radio, summarized the consensus among classical musicians that "the story will end with four losers and no real winner."[22]

Evidently, the classical music world was not familiar with the Coase Theorem.

II. Coasean Bargaining and Emergence from Bankruptcy

To the classical music world, the bankruptcy court's decision to liquidate the Audubon's instruments was unjust because the musicians lost property that they, uniquely, valued. The instruments were attached to their "souls" and crucial to their earning a living.[23] Put otherwise, since they were the highest-valuing users of the instruments, a proper allocation of legal entitlements would allow them to keep the instruments.

The Coase Theorem, however, teaches that an efficient allocation of resources does not require an efficient initial distribution. Rather, irrespective of initial distributions, parties will, absent transaction costs, sell and trade resources until the highest-valuing user of each resource possesses it.[24]

---

16. *Id*
17. *Id.*
18. *Id.*
19. Daniel J. Wakin, *The Broken Chord*, N.Y. TIMES, Dec. 11, 2005, http://www.nytimes.com/2005/12/11/arts/music/11waki.html.
20. *Musicians Abhor Continued Litigation Against Audubon Quartet Members*, AUDUBON QUARTET, http://www.audubon4tet.com/musicianspetition.pdf (last visited Dec. 5, 2011).
21. Wakin, *supra* note 19.
22. Rose, *supra* note 5.
23. *See supra* notes 18-20 and accompanying text.
24. Ronald H. Coase, *The Problem of Social Cost*, 3. J.L. & ECON. 1 (1960); *see* A. MITCHELL POLINKSI, AN INTRODUCTION TO LAW AND ECONOMICS 14 (3d ed. 2003).

Moreover, it is impossible to know with certainty who the highest-valuing user of a given resource even is until parties are given a chance to trade resources and reveal their preferences. Thus, legal systems like bankruptcy should focus not on efficient initial distributions, but instead on allocating entitlements in ways that minimize transaction costs, allowing parties to bargain their way to socially efficient outcomes.[25]

Legislatures have enacted tools of the trade exemptions in attempts to be consistent with the goal of minimizing transaction costs. In a world of zero transaction costs, it would not matter if debtors' possessions were liquidated and sold because debtors could simply buy the possessions back if they were truly their highest-valuing users. But the entire premise of bankruptcy is that debtors are constrained by a huge transaction cost: inadequate wealth.[26] Even if a debtor is the highest-valuing user of her possessions, she cannot buy them back if she has no money. Hence the tools of the trade exemption. The exemption's purpose, in the words of Judge Posner, is to prevent a debtor from being "forced out of his trade."[27] This provides a debtor with an opportunity to "rehabilitate himself financially,"[28] which in turn allows the debtor to buy back any liquidated possessions of which he is the highest-valuing owner.

Yet this justification for the tools of the trade exemption[29] not only requires inadequate debtor wealth, but also requires broader market illiquidity. The intrinsic value of the "tools" themselves is not what enables the debtor to rehabilitate himself financially and obtain a fresh start. Rather, it is their value in enabling the debtor to generate future income streams. If a debtor is truly capable of being profitable in her "trade" going forward, one would expect third parties to simply lend her money to procure the necessary "tools" for profitability in that trade even if she lost them in bankruptcy.[30]

In the case of the Audubon String Quartet, this is precisely what happened. No less than a month after the bankruptcy court ordered the

---

25. *See* James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955, 965-66 (1994); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1809 (1998).

26. Although wealth effects are not "costs" in the conventional sense of the term, they are best conceptualized as a transaction cost for the purposes of the Coase Theorem because they are impediments to bargaining.

27. *In re* Patterson, 825 F.2d 1140, 1146 (7th Cir. 1987).

28. William T. Vukowich, *Debtors' Exemption Rights*, 62 GEO. L.J. 779, 786 (1974).

29. Case law across jurisdictions affirms that the tools of the trade exemption is intended to allow debtors to generate future income. *See, e.g.*, *In re* Aurelio, 252 B.R. 102, 107 (Bankr. N.D. Miss. 2000) ("In order to claim a tools of the trade exemption, one must be engaged in a particular trade or profession at the time of filing or have formerly been engaged in the trade or profession and have the present intent to resume the trade."); Sun Cnty. Distribs. of La., Inc. v. Starkey, 637 So. 2d 739, 740 (La. Ct. App. 1994) (stating that the exemption only applies to tools that are "necessary for the exercise of the [debtor's] profession").

30. This may be contrasted with most other debtor exemptions, which exempt property with self-contained values. *See, e.g.*, 11 U.S.C. § 522(d)(2) (2006) (allowing debtors to exempt a motor vehicle). With those possessions, wealth disparities alone might serve as an impediment to Coasian bargaining because the possessions would not necessarily generate future cash flows to repay a lender.

instruments liquidated, a third party stepped in. That third party was Daniel Braden, a wealthy freelance musician who buys instruments as an investment and lends them to professional musicians. Braden agreed to purchase the Quartet's instruments for $200,000, conditioned upon Ehrlich accepting that sum in full satisfaction of the original judgment he had won in Pennsylvania court.[31] Braden then lent the instruments back to the Quartet members for a period of ten years, at which point the musicians would have the opportunity to re-acquire the instruments from him if they could afford it.[32] And if anyone should posit Braden was motivated purely by altruism, think again: "I want to make it very clear, I'm not a donor," he told *The New York Times*. "I'm buying the instruments [as an investment] and loaning them back to [the Quartet]."[33] Thus, thanks to Coasean bargaining, the initial despondency of Shaw, Lederer, and the classical music world proved to be superfluous. As its thirty-fifth anniversary tour demonstrates, the Quartet survived the bankruptcy proceedings. The musicians regained their residency at the Shenandoah Conservatory, and all of the pre-2000 members other than Ehrlich remained Quartet members until the Quartet decided to disband several years later.[34] Although the Quartet dissolved in 2011, its members continue to perform, and they retain their positions at Shenandoah University.[35]

As the Coase Theorem suggests, therefore, the tools of the trade exemption proved unnecessary for the Audubon members to maintain possession of their instruments. Ironically, however, if there ever was a "tools of the trade" case in which the barriers to Coasean bargaining were high, it was the case of the Audubon Quartet. First, the value of the Quartet's instruments was far greater than the value of the tools in most tools of the trade exemption cases.[36] More expensive tools require more market liquidity for loans because investors have to be willing to part with more upfront capital to realize their eventual returns.[37] Second, unlike most tools of the trade, the Audubon's

31. Given the Quartet's limited personal assets, Ehrlich was unlikely to receive his full damages even without a settlement.

32. Daniel J. Wakin, *How Audubon Musicians Kept Their Instruments*, N.Y. TIMES, Feb. 7, 2006, http://www.nytimes.com/2006/02/07/arts/music/07audu.html.

33. *Id.*

34. *See Audubon Quartet*, LOIS SCOTT MGMT., INC., http://www.loisscottmanagement.com/audubon.php (last visited Dec. 16, 2011); Press Release, Audubon String Quartet, *supra* note 1.

35. Allen, *supra* note 1.

36. Even the most generous exemptions, designed to encompass most debtors' "tools," are capped well below the value of the Quartet's instruments. *See supra* note 15 and accompanying text. Even in machinery-heavy industries, such as farming, the requisite tools may be less expensive than classical instruments. *See, e.g., In re* Patterson, 825 F.2d 1140-1141 (7th Cir. 1987) (stating that fifty-one cows and a tractor were auctioned for $24,600, roughly $48,000 in today's dollars.)

37. A counterargument to this point is that many large banks avoid micro-loans because of the fixed administrative costs for each loan. However, a robust business of micro-creditors has developed in the United States in recent decades to provide this capital. *See* Jay MacDonald, *Micro-Loans Help Smallest, Neediest Startups Grow*, BANKRATE (Oct. 13, 2000),

instruments were not only means of income generation, but also had intangible value connected to the musicians' senses of self.[38] For such possessions connected to a debtor's personhood, wealth disparities alone might serve as an impediment to Coasean bargaining because the personhood value cannot be liquidated into future cash flows. Yet, in spite of these two potential obstacles, lending markets proved sufficiently liquid to facilitate Coasean bargaining and allow the Audubon to regain possession of its instruments.

The Audubon's tragicomic saga, then, is more than an entertaining story. That the Quartet regained their instruments without the assistance of the tools of the trade exemption, despite the presence of circumstances suggesting the exemption would be particularly necessary, throws into question whether the exemption is ever necessary.

A skeptic might counter that the substantial publicity surrounding the Audubon's saga might have helped secure Braden's loan and that this publicity is not present in most bankruptcy cases. The wide availability of micro-loans to relatively unknown start-up companies of all kinds,[39] though, suggests that publicity surrounding the Audubon bankruptcy was not a prerequisite for Coasean bargaining. Indeed, if anything, the publicity associated with the case suggests that it might be a rare window into widespread—but unpublicized—Coasean bargaining in bankruptcy liquidations. Unlike Braden's decision to buy the Quartet's instruments and lend them back, a typical loan to a debtor who lost the tools of his trade would not be covered in *The New York Times*, and, therefore, would not be available for scholarly citation and analysis.

III. Costs of the Exemption and Conclusion

The irrelevance of tools of the trade exemptions to debtors' ability to regain financial footing would be a purely academic matter if the exemption did not carry costs of its own. Unfortunately, it does. Indeed, one of the more significant negative impacts of the tools of the trade exemption is on market liquidity, the very phenomenon that permits Coasean bargaining in bankruptcy liquidations in the first place. As Judge Easterbrook explained in a case on the subject:

> Any fresh-start policy must balance the gains from new beginnings against the costs of making it harder for lenders to collect. The more difficult collection becomes, the fewer assets are available to secure loans, the costlier is credit. Every expansion of . . . [a tools of the trade]

---

http://www.bankrate.com/brm/news/biz/Capital_borrowing/20001013.asp (discussing the ease with which small businesses can secure micro-loans as compared to larger loans).

38. *See supra* notes 18-22 and accompanying text.

39. *See* MacDonald, *supra* note 37. Although lending has tightened during the recession, this tightening results from broader macro-economic conditions rather than insufficient lender information. *See* Elizabeth A. Duke, Governor, Fed. Reserve Bd., Address at the 2011 International Factoring Association Conference: Small Business Credit Availability (Apr. 14, 2011), http://www.federalreserve.gov/newsevents/speech/duke20110414a.htm.

> exemption statute makes loans riskier for banks and so raises the interest rate (or makes banks unwilling to lend at all to some people). This effect, which burdens the frugal and spendthrift alike, can swamp the gains of fresh starts.[40]

This cost is not merely theoretical. Several studies by economists demonstrate that the marginal risk of credit default has tangible impacts on lending interest rates.[41] While these studies do not quantify the impact of the tools of the trade exemption specifically, the exemptions subject close to $1 billion of credit, annually, to additional risk.[42] At this volume, it is difficult to imagine that the tools of the trade exemption does not have at least some impact on credit availability. Thus, the tools of the trade exemption not only is unnecessary for promoting efficiency in bankruptcy liquidations, but it also creates new transaction costs that may actively preclude efficiency.

Nor can the tools-of-the-trade exemption be justified on distributive grounds. It is true that allowing bankrupt debtors to keep their tools, rather than requiring them to buy new ones through a loan, provides them with a wealth gain equal to the value of the tool (though not equal to the stream of revenue the tool generates, which they could receive anyway). Yet this wealth gain comes largely at the expense not of lenders, but of other high-risk debtors. These debtors are equally subjected to the higher interest rates resulting from the credit risk created by the tools of the trade exemption,[43] yet they will receive no benefit from the exemption. In other words, the tools of the trade exemption generates a wealth transfer from poor individuals who do not default on their debts to poor individuals who do. It hurts most acutely the segment of society that is arguably most in need of support and creates a perverse financial incentive for individuals to file for bankruptcy when they otherwise would not do so.

A similar moral hazard exists for forgiveness of debts incurred through tort, such as the Audubon members' damages to Ehrlich. The easier it is for debtors to avoid payment of tort damages through bankruptcy, the less effective the tort system will be in achieving its objectives, be they deterring normatively wrongful behavior or efficiently allocating social costs. Such "judgment

40. *In re* Erickson, 815 F.2d 1090, 1094 (7th Cir. 1987).

41. *See, e.g.*, Satyajit Chatterjee et al., *A Quantitative Theory of Unsecured Consumer Credit with Risk of Default*, 75 ECONOMETRICA 1525 (2007); Jan Ericsson & Olivier Renault, *Liquidity and Credit Risk*, 61 J. FIN. 2219 (2006).

42. From 2007 to 2010, there were an average of roughly 80,000 non-business Chapter 7 bankruptcy filings each year. For the data used to calculate the average, see *Annual Non-Business Filings by Chapter (2007-2010)*, AM. BANKR. INST., http://www.abiworld.org/AM/Template.cfm?Section=Annual_U_S_Filings1&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=62&ContentID=36294 (last visited Dec. 5, 2011). Even states with low caps for the tools of the trade exemption generally allow roughly $1000, while many states allow much more. *See supra* note 14 and accompanying text.

43. *See* Chatterjee et al., *supra* note 41, at 1527 ("[T]he price charged on a loan of a given size made to a household with given characteristics exactly compensates lenders for the objective default frequency on loans of that size made to households with those characteristics.").

proofing" through bankruptcy has been well documented in the context of large companies looking to deflect mass tort claims.[44] There is no reason to believe individuals, when feasible, would not attempt to similarly use bankruptcy to insulate themselves from tort judgments.

This is not to argue against all policies that help give debtors a fresh start by limiting creditors' ability to collect.[45] It is to say that this objective would be served better by exemptions that focus not on tools of the trade, but rather, as several other exemptions do, on personal items with little value on the open market and no ability to generate future revenue streams.[46] Exempting these items would have little marginal impact on liquidity and interest rates because creditors would not be able to recoup capital through their liquidation in the first place. And they likely have greater intrinsic value to debtors, since they are not merely means to future income streams that debtors would be able to obtain anyway. The tools of the trade exemption, in contrast, has little to offer by way of giving debtors a fresh start that they could not already receive, and it generates a host of unnecessary costs for debtors and creditors alike.

To the self-appointed legal analysts of the classical music world, the Audubon's bankruptcy revealed that the limits on the tools of the trade exemption were unjustly low.[47] This inference was gravely mistaken. The actual implication of the Audubon's saga is that the tools of the trade exemption may not be valuable at all.

---

44. *See* Lynn M. LoPucki, *Virtual Judgment Proofing: A Rejoinder*, 107 YALE L.J. 1413, 1413, 1418-1420 (1998); Steve Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986).

45. *See generally* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985) (discussing the potential benefits of such policies).

46. *See, e.g.*, 11 U.S.C. § 522(d)(3) (2006) (exempting household furnishings).

47. *See supra* notes 15-20 and accompanying text.