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ARTICLES

CORPORATE GOVERNANCE IN THE BANKRUPTCY REORGANIZATION OF LARGE, PUBLICLY HELD COMPANIES†

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In the decade of the 1980s, the bankruptcy reorganization of companies worth hundreds of millions or even billions of dollars became commonplace. The companies that sought the protection of the bankruptcy courts were usually in tremendous upheaval.¹ Under bankruptcy law, it fell to the incumbent managers to decide

¹ At the time they filed, the majority of the 43 companies we studied were losing millions, or tens of millions, of dollars each month. See Table I, *infra* note 25.

how to respond to these problems. Their decisions were often between courses of action that would serve either the interests of their shareholders or the interests of their creditors, one at the expense of the other.² For example, upon filing, the management of Continental Airlines suspended all flights, locked its union work force out, and resumed operations only as it was able to hire nonunion replacements. At the time they did so, there was considerable doubt as to whether the plan could work. From the standpoint of the company, it was a desperate gamble.³ But from the standpoint of the shareholders who were firmly in control of the company, it was hardly a gamble at all. The alternative was a liquidation in which they would recover virtually nothing; the reopening would be almost entirely at the risk of creditors. Taking the opposite course late in the Manville Corporation bankruptcy, management of the nearly solvent company sided with its commercial creditors against its shareholders. Management backed a reorganization plan that left the old shareholders with only a nominal interest in the emerging company, while simultaneously providing the unsecured bank lenders payment in full—with interest those lenders could not have won in a contested hearing.⁴ The deal relegated the asbestos health claimants to the position of shareholders in the emerging company, a position that quickly proved inadequate to satisfy their mounting claims.⁵

Decisions such as these raise two important questions in stark relief. The first is who the management of a reorganizing company is normatively supposed to represent. Surprisingly, neither the law⁶ nor legal theory⁷ can provide a consistent, coherent answer.

² See *infra* notes 53-70 and accompanying text.

³ See Bryan Burrough et al., *Continental Air Reopens in Chaos With Reduced Flights, Lower Fares*, WALL ST. J., Sept. 28, 1983, at 31.

⁴ See *In re Johns-Manville Corp.*, 68 B.R. 618, 634 (Bankr. S.D.N.Y. 1986).

⁵ See Stephen Labaton, *Asbestos Trust Fund of Manville Queried*, N.Y. TIMES, May 16, 1990, at D1; Stephen Labaton, *Manville Trust Fund in Trouble*, N.Y. TIMES, Feb. 7, 1989, at D1; Cynthia F. Mitchell, *Manville Trust May Be Forced Into Stock Sale*, WALL ST. J., Feb. 8, 1989, at A6.

⁶ For example, the case law is in conflict as to whether the shareholders of an insolvent company are entitled to vote managers out of office during reorganization if the managers do not serve the interests of shareholders. See *infra* notes 93-108 and accompanying text.

⁷ Those legal theorists who have recently addressed the question have tended toward the view that the management of an insolvent, reorganizing company should be loyal to creditors, not shareholders. See Douglas G. Baird, *Fraudulent Conveyances, Agency Costs, and Leveraged Buyouts*, 20 J. LEGAL STUD. 1, 12 n.18 (1991) ("When the firm becomes insolvent, the fiduciary duty of the directors shifts from the sharehold-

The second is who these managers in fact represent. Perhaps because there is a well-developed body of theory that purports to demonstrate that the managers of solvent companies will act in the shareholders' best interests, most leading theorists simply assume that the same is true for insolvent and reorganizing companies. In their models, they assume managers and shareholders to be in perfect alliance.⁸ Others, equally without empirical data or supporting analysis, assert that managements act on behalf of creditors once a company becomes insolvent.⁹

We address both questions in this Article. We show empirically that neither the assumption of shareholder control nor the assumption of creditor control is correct. The process by which the behavior of managements of insolvent, reorganizing companies is influenced and controlled is complex and in many ways haphazard. It differs from case to case. The results are often troubling from a normative perspective. We also show that creditor and shareholder influence over management frequently prevents companies from maximizing their value.

ers to the creditors."); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 762 n.58 (1988); David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 463 (1992) (arguing that "unsecured creditors, rather than shareholders, should be the voters in any directorial election"). We discuss and criticize this point of view *infra* notes 328-39 and accompanying text.

⁸ For example, even though the Bankruptcy Code gives the exclusive right to file a plan to the debtor-in-possession, see 11 U.S.C. § 1121 (1988), with the result that it is exercised by management, Bebchuk considers it to be in the hands of shareholders. See Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 799 (1988) ("Under the existing rules, the equityholders usually have the exclusive right for a specified period of time to file (and seek confirmation of) a reorganization plan."); see also LUCIAN A. BEBCHUK & HOWARD F. CHANG, *BARGAINING AND THE DIVISION OF VALUE IN CORPORATE REORGANIZATION* 4, 18 (Harvard Law School Program in Law and Economics No. 80, 1990) ("As already noted, the equityholders have control over the agenda for the first six months of bargaining, and the courts often extend this period."). Others are only slightly more cautious. See Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 748 (1989) ("[E]quityholders . . . possess the prerogative to enter and protract the reorganization process while *their* managerial representatives retain control of the firm.") (emphasis added); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 266-67 (1987) ("[T]he current framework for reorganization gives managers, presumed to be allies of shareholders, substantial control over the reorganization process.").

⁹ See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 404 (1983) ("[S]hareholders lose the controlling votes when their shares are under water [sic]; managers become answerable to other investors.").

In recent years it has become fashionable to argue in the strongest terms that management has too much power in chapter 11 proceedings and that they exercise it in a self-serving manner.¹⁰ These issues have a significant historical dimension. Prior to 1939, the structure for governance of reorganizing companies was much the same as it is today. Managers remained in office and played a major role in determining the course of the reorganization. Under the direction of William O. Douglas, the Securities and Exchange Commission conducted a number of empirical studies of the operation of the reorganization process. The SEC concluded that managements responsible for the companies' problems tended to remain in office and act in a self-serving manner to the detriment of public investors.¹¹

In 1939, the system was reformed by providing that upon the filing of a reorganization case by a large, publicly held company, the company's management would be replaced by a court-appointed

¹⁰ In a recent article, Bradley and Rosenzweig ask "is Chapter 11 . . . appropriately viewed as a mechanism that permits managers to abridge contractual agreements with creditors and other stakeholders in order to enhance their own welfare?" Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1048 (1992) [hereinafter Bradley & Rosenzweig, *Untenable Case*]. They answer their own question in an article about their article. See Michael Bradley & Michael Rosenzweig, *Time to Scuttle Chapter 11*, N.Y. TIMES, Mar. 8, 1992, at F13 ("[W]e believe that the principal beneficiaries of Chapter 11 are corporate managers . . . Chapter 11 . . . in fact serves mainly to protect manager's jobs."). Other commentators echo the same views:

During the Eighties, Chapter 11 became . . . a powerful tool of megacorporations. . . . Chapter 11 permitted megacorporations . . . [and] the men who ran them to escape the consequences of their greed and incompetence. If viewed as a government program to provide large amounts of aid to giant corporations, the Bankruptcy Code has been one of the most successful federal programs.

LAURENCE H. KALLEN, CORPORATE WELFARE: THE MEGABANKRUPTCIES OF THE 80S AND 90S at ix (1991); see also *id.* at 468 ("Often . . . one must wonder just what has happened [in a chapter 11 proceeding]. The answer is simple: the jobs, salaries, and perks of those in the executive suite . . . have been 'saved.'"); Kevin J. Delaney, *Power, Intercorporate Networks, and "Strategic Bankruptcy"*, 23 LAW & SOC'Y REV. 643, 663 (1989) (asserting that characterizing bankruptcy as simply an instrument employed to achieve economic efficiency ignores its use to preserve power by management, among others); Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 ARIZ. L. REV. 89, 131 (1992) (describing the potential desire of managers to prolong reorganization in an effort to retain their jobs).

¹¹ See U.S. SEC. & EXCH. COMM'N, REPORT ON THE STUDY & INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937-40) pt. 8 at 319-20 [hereinafter DOUGLAS REPORT]. For more information about this study and the corporate reorganization system about which it reported, see *infra* notes 79-82 and accompanying text.

trustee.¹² Perhaps predictably, the managements of ailing companies chose not to surrender their control to trustees. Chapter X of the Bankruptcy Act, which embodied the 1939 reforms, fell into disuse. Congress repealed chapter X in the "reform" of 1979.¹³ The system returned to the pre-1939 practice under which the managers of the debtor company remained in office and trustees were rarely appointed. The flow of large, publicly held companies through the bankruptcy reorganization process resumed slowly at first, but now has built to a steady procession.¹⁴ The question is whether this resumption of reorganization under management control has been accompanied by a resumption of the management abuses that led to the 1939 reform. Our conclusions on this point are less certain. We have found that managements are often able to exploit power for their own benefit. But we have also found that management is highly vulnerable to the power of others. That vulnerability is perhaps best demonstrated by the high rate of turnover of both the managements that presided over the companies' declines and the managements that replaced them.¹⁵

This Article is based on an empirical study of the forty-three largest publicly held companies to file and complete a bankruptcy reorganization between 1979, when the new Code became effective, and 1988.¹⁶ We have attempted to discover the actual practices

¹² See Chandler Act, ch. 575, 52 Stat. 840, 885 (1938).

¹³ See Act of Nov. 6, 1978, Pub. L. No. 95-598, § 401, 92 Stat. 2549, 2682 (codified as amended at 11 U.S.C. §§ 101-1501 (1988)).

¹⁴ The best information on the rate of bankruptcy filings by publicly held corporations is provided by the SEC, which maintains a list of all companies with publicly held securities that file a chapter 11 petition. Those lists show that the rate of filings increased substantially during the first half of the 1980s and thereafter leveled off. For publicly held companies claiming assets of \$100 million or more at filing, there were only two filings in fiscal year 1980, but this number had risen to 14 by fiscal year 1986 and has since remained at about that level. In fiscal year 1990, the most recent year for which we have data, there were 17 such filings. See Securities & Exchange Comm'n, Public Companies Filing Chapter 11 Petitions (unpublished data, on file with authors).

¹⁵ These conclusions are based on the empirical study described in the next paragraph of the text. Our findings in this respect are reported *infra* notes 187-224 and accompanying text.

¹⁶ This project was designed to discover what is happening in the so-called "megabankruptcies." We studied all cases filed after October 1, 1979 (the effective date of the new Bankruptcy Code), in which a plan was confirmed before March 15, 1988, if the debtor reported at least \$100 million in assets in its petition and had at least one issue of debt or equity security registered with the Securities and Exchange Commission. A primary area of inquiry in this research has been the process of plan negotiation and confirmation, with special attention paid to the fate of junior creditor and shareholder classes. Our findings in this regard are reported in Lynn M. LoPucki

with respect to corporate governance in these kinds of cases. In the course of our study we collected and reviewed documents from the court files,¹⁷ other publicly available information concerning the debtor corporations such as SEC filings, and newspaper and journal articles about both the companies and the cases. We also conducted more than 120 personal interviews with lawyers who played key roles in these cases. Many of our conclusions about management's role in these cases are based on these interviews.¹⁸

Part I of this Article describes the context in which the issues of corporate governance typically arise and the common sources of conflict among management, shareholders, and creditors. We also review other studies which bear on the corporate governance issues we address. Part II describes the sources of management power and the means by which that power is limited or controlled by various constituencies. In Part III, we examine the uses managements made of their power. We attempt to assess how much power managements had and for whose benefit they applied it. In Parts II and III, our discussion is informed both by theoretical perspectives that would attempt to predict a priori how management should behave and our empirical findings on how they in fact did behave. In Part IV we evaluate a proposal to avoid the problem of corporate governance by requiring an auction sale of the company shortly after the filing of the case. We express serious doubt. Part V addresses the normative question that lies at the center of the

& William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 178 (1990) [hereinafter LoPucki & Whitford, *Bargaining Over Equity's Share*]. In a second article, we reported on forum shopping practices in these cases and suggested possible legislative responses. See Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 57-58 [hereinafter LoPucki & Whitford, *Venue Choice*]. A forthcoming article will report on the levels of success achieved in the reorganization cases we studied. See Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. (forthcoming May 1993) [hereinafter LoPucki & Whitford, *Patterns*]; see also Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625, 625-28 (1991) [hereinafter LoPucki & Whitford, *Preemptive Cram Down*] (advocating the extinguishing of shareholder interests in the cases of insolvent debtors).

¹⁷ For each case we obtained the court order confirming the plan of reorganization, the confirmed plan of reorganization, and the disclosure statement prepared for that plan.

¹⁸ Though individual interviews are the source of much of the information we present here, we do not cite to the interviews because we have guaranteed the interviewees confidentiality. See also *infra* notes 184-85 and accompanying text (discussing the specifics of our interviewing process).

article: for whose benefit should management govern the large, publicly held company in bankruptcy reorganization?

I. THE BANKRUPTCY CONTEXT

A. *The Legal Procedure for Reorganization*

When a corporation is unable to pay its debts as they become due, one solution may be to "restructure" the debt. The restructuring may be merely a postponement of the time for payment, or it may include a reduction in the amount owing or conversion of some of the debt into equity interests. A restructuring may be accomplished without the filing of a bankruptcy reorganization case, but there are advantages in filing. First, in bankruptcy reorganization cases, specified majorities of creditors can bind dissenting minorities of the same class through voting.¹⁹ No corresponding power to bind dissenters exists in the absence of bankruptcy.²⁰ Second, the automatic stay protects the debtor from the collection efforts of creditors.²¹ This protection ordinarily lasts for the duration of the case. While the stay remains in effect, the debtor can operate its business and continue receiving the cash flow from operations, but suspend payment on some or all of its debt. One result is often an immediate, dramatic improvement in cash flow. Another may be to increase the pressure on creditors to consent to a debt restructuring. Once the stay is in effect, often the quickest way for a creditor to obtain a resumption of payments is to consent to a plan that restructures the debt.²² There are many other potential advantages in reorganizing through bankruptcy, rather than an out-of-court workout.²³

¹⁹ This voting procedure is described *infra* notes 42-47 and accompanying text. A bankruptcy reorganization plan can also be approved over the dissent of particular creditors by what is called a "cram down" procedure, *see* 11 U.S.C. § 1129(b) (1988), but approval in this manner is less common in the cases of large, publicly held companies, *see infra* notes 48-51 and accompanying text.

²⁰ *See* *Roe*, *supra* note 8, at 236-46 (discussing how "buoying-up," spurred by individually acting owners and creditors, subverts a firm's ability to reorganize outside bankruptcy).

²¹ *See* 11 U.S.C. § 362 (1988).

²² Payments to unsecured creditors on prepetition claims during chapter 11 cases are rare. *See* LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 542-43 (2d ed. 1991). Judges, however, may approve such payments in certain cases. *See id.* at 542 n.14. The rarity of these payments makes chapter 11 markedly different from chapter 7 and chapter 13 proceedings, in which interim payments are common, even required.

²³ Although it is possible to avoid immediate taxation of debt forgiveness as

In discussing the decisions that must be made as part of a reorganization, bankruptcy professionals distinguish between the "business plan" and the "reorganization plan." Though some businesses have operations that are healthy at the time they file for reorganization,²⁴ most are incurring substantial losses from ongoing operations.²⁵ The set of decisions by which the company

ordinary income in an out-of-court restructuring, it may be easier to do so in bankruptcy. See 26 U.S.C. § 108(a)(1)(A)-(B) (1988) (providing for nonrecognition of debt forgiveness income in all bankruptcy cases, but otherwise only if debtor is insolvent). Particular debtors may find advantage in the bankruptcy rules permitting rejection of executory contracts, the recovery of property preferentially or fraudulently transferred by the debtor in the past, or in other provisions of bankruptcy law. See, e.g., 11 U.S.C. §§ 365, 547 (1988).

²⁴ The Johns-Manville Corporation is an example from among the cases that we studied. Shortly after filing for bankruptcy reorganization, the company ran full page advertisements proclaiming that, aside from the company's liability for injuries from asbestos, its business was in good health. See N.Y. TIMES, Aug. 27, 1982, at D3.

²⁵ Operating losses were reported in 26 of the 41 cases for which we had information, and in all but three of those 26 cases the losses exceeded \$10 million annually. Though the losses may in part reflect peculiarities in the application of accounting principles in periods of severe distress, operating losses of that magnitude suggest that more than a financial restructuring was needed to return the company to profitability.

TABLE I
OPERATING INCOME IN LAST FISCAL YEAR COMPLETED BEFORE FILING
(in millions)

Name of Case	Net Operating Income (Loss)	Name of Case	Net Operating Income (Loss)
Air Florida	(\$11.29)	AM International	(20.38)
Amarex	20.83	Anglo Energy	(14.03)
Baldwin-United	(123.92)	Braniff	(94.90)
Charter	214.78	Combustion Equipment	4.64
Continental Airlines	(34.59)	Cook-United	(12.84)
Crystal Oil	(16.46)	Dreco	27.49
Energetics	(31.92)	EPIC	Not Available
Evans Products	12.04	FSC	16.90
HRT	15.75	Itel	75.10
Johns-Manville Corp.	(59.27)	KDT	(2.83)
Lionel	163.66	Marion	(17.95)
McLouth	(32.03)	MGF	(60.97)
NuCorp	(27.03)	Oxoco	(55.45)
Penn-Dixie	(7.24)	Phoenix Steel	(7.65)

hopes to reverse those losses and restore the financial health of the company is commonly referred to as the "business plan."²⁶ The business plan typically calls for the sale or abandonment of unprofitable parts of the business and reductions in the expenses of those parts that are retained, but many other kinds of plans are possible.

The second set of decisions relates to the financial restructuring. It includes decisions as to what classes of creditors and shareholders should share in the estate, and what kinds or combinations of cash, notes, debentures, and shares²⁷ each should receive. This second set of decisions is embodied in a document called the "plan of reorganization," which must be "confirmed" by the bankruptcy court.²⁸

With regard to both sets of decisions, bankruptcy procedure thrusts management of the debtor corporation into a central role. Upon the filing of the reorganization case, the debtor corporation becomes a "debtor in possession."²⁹ Its management continues in office. Except in those rare cases in which the court orders otherwise, the debtor-in-possession is authorized to operate the

Pizza Time Theatre	(69.76)	Revere	19.68
Salant	(16.12)	Sambo's Restaurants	14.13
Saxon	6.10	Seatrain Lines	17.66
Smith International	Not Available	Storage Technology	(12.30)
Tacoma Boatbuilding	(22.76)	Technical Equities	15.73
Towle	(51.90)	Towner	(29.38)
White Motor	(53.54)	Wickes	(63.96)
Wilson Foods	23.24		

Calculations of net operating income were made using information provided in the respective company's 10K filed with the SEC, annual report, or Moody's report for the full financial year prior to filing for bankruptcy. When necessary, we adjusted what a company reported as operating income to exclude interest payments, income taxes, or tax benefits.

²⁶ Bankruptcy law does not formally recognize or regulate the "business plan," but that term is in widespread use among bankruptcy professionals. *See, e.g., In re White Motor Credit Corp.*, 14 B.R. 584, 587 (Bankr. N.D. Ohio 1981) ("[The debtor] has submitted an extensive 'Business Plan' [to the court].").

²⁷ Sometimes there will also be securities of other corporations, received by the reorganizing corporation in exchange for a transfer of assets as part of the business plan, available for distribution as part of the reorganization plan.

²⁸ *See* 11 U.S.C. §§ 1123, 1129 (1988). When confirmed by the court, a reorganization plan alters the legal rights of creditors, shareholders, the debtor, and other parties to the case. *See id.* § 1141.

²⁹ *See id.* § 1101(1).

business,³⁰ and it is the debtor's management who actually do so. They have authority to determine what changes in business operations are necessary—that is, to propose and implement a business plan.³¹ The Bankruptcy Code also gives the debtor, normally acting through its management, the exclusive right to propose a reorganization plan during the first 120 days of the case and such additional periods as the court may order.³² This right is generally referred to as the “right of exclusivity” or simply “exclusivity.”

In reorganization cases involving large companies, there are typically thousands of creditors and shareholders who are “parties in interest,” with the right to participate. In the aggregate, the interests of these creditors and shareholders are likely to be sufficient to warrant the costs of monitoring the debtor and participating in the reorganization case. Yet the interest of any particular creditor or shareholder is likely not to be sufficient to warrant the cost of that creditor or shareholder's participation. As it is usually expressed in economic theory, the creditors and shareholders have a “collective action” problem.³³

To deal with this problem, the Bankruptcy Code provides for the appointment of committees of creditors and equity holders to represent parties similarly situated. With the approval of the court, the committees can hire professionals to represent them, including attorneys, accountants, and financial advisers.³⁴ The fees of these professionals are paid by the debtor corporation,³⁵ effectively passing these costs on to some or all of the persons who will share in distributions under the reorganization plan. These committees have the right to consult with management, to participate in the formulation of a reorganization plan, and to challenge management's actions in court.³⁶

³⁰ See *id.* §§ 1107(a), 1108.

³¹ For limitations on management's authority over the business plan, see *infra* notes 83-86 & 134-38 and accompanying text

³² See 11 U.S.C. § 1121(d) (1988). The exclusivity period is commonly extended in cases involving large, publicly held companies. See *infra* notes 88-90 and accompanying text.

³³ See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION 2* (1971) (“[E]ven if all of the individuals in a large group are rational and self-interested, and would gain if, as a group, they acted to achieve their common interest or objective, they will still not voluntarily act to achieve that common or group interest.”).

³⁴ See 11 U.S.C. § 1103(a) (1988).

³⁵ See *id.* § 330(a).

³⁶ See *id.* § 1103(c).

The Code requires that an unsecured creditors' committee be appointed in every case.³⁷ In fact, such a committee was appointed and organized in all but one of the cases in our study.³⁸ The U.S. Trustee has the authority to appoint such additional committees of creditors or shareholders as the U.S. Trustee deems appropriate, and upon request of a party in interest, the court may order the appointment of additional committees.³⁹ Equity committees were appointed in twenty-two of the forty-three cases in our study (fifty-one percent),⁴⁰ and additional committees representing particular groups of creditors were appointed in twenty of the forty-three cases.⁴¹

The Bankruptcy Code's procedures for creditor and shareholder participation in the approval of reorganization plans are elaborate. Before a plan can be submitted for a vote, the court must approve a disclosure statement explaining the proposed plan and providing other useful information to assist creditors and shareholders in voting on the plan.⁴² A proposed plan must divide claims and interests into classes,⁴³ with all claims or interests in a class treated alike.⁴⁴ Votes on the plan are tallied by class. A class of claims has accepted a plan if the holders of at least two-thirds in amount and more than half in number of the allowed claims voting in the class have accepted the plan.⁴⁵ A class of interests has accepted a

³⁷ See *id.* § 1102(a)(1).

³⁸ In the one case in which no unsecured creditors' committee was appointed, EPIC, there was one very large unsecured creditor which was also the principal shareholder of the debtor. This creditor was going to participate in the case whether or not a committee was appointed. There was no collective action problem with respect to representation of its position. In EPIC there were many secured creditors with modest claims and a committee was appointed to represent their interests.

³⁹ See 11 U.S.C. § 1102(a) (1988). Through most of the period of our study, the U.S. Trustee program was in effect in only 18 districts, including the important jurisdiction of the Southern District of New York. See 28 U.S.C. § 581(a) (1982) (amended 1986). In other districts, a bankruptcy judge appointed the committees. See 11 U.S.C. § 1102(a) (1982) (amended 1984 & 1986).

⁴⁰ See LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 139. Another recent study of large reorganization cases reports the formation of 29 equity committees in 68 cases (43%). See Brian L. Betker, *Management Changes, Equity's Bargaining Power and Deviations from Absolute Priority* in Chapter 11 Bankruptcies at 11 (Oct. 1991) (unpublished manuscript, on file with authors).

⁴¹ A case-by-case breakdown of these committees appears at LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 139.

⁴² See 11 U.S.C. § 1125 (1988).

⁴³ See *id.* § 1123(a)(1).

⁴⁴ See *id.* § 1123(a)(4).

⁴⁵ See *id.* § 1126(c).

plan if the holders of at least two-thirds in amount of the allowed interests voting in the class have accepted the plan.⁴⁶ If all impaired classes accept the plan, and it satisfies other statutory requirements, it will be confirmed and modify the legal rights of even those who voted against it.⁴⁷

If some impaired classes, but less than all,⁴⁸ reject the plan, the bankruptcy judge can confirm it nevertheless, if it is "fair and equitable" and does not "discriminate unfairly" against the rejecting classes.⁴⁹ To be "fair and equitable," the plan must comply with what is known as the absolute priority rule—meaning either that the dissenting classes are paid in full or that classes with lesser priority than the dissenting classes receive nothing.⁵⁰ When a plan is confirmed despite a class' rejection of it, the plan is said to be "crammed down" against the class.

In the bankruptcy reorganizations of large, publicly held companies, plans are rarely crammed down against resisting classes of creditors or shareholders. There is a widespread belief among practitioners that cram down is expensive and impractical.⁵¹ As a consequence, plan proponents place considerable emphasis on winning the vote of all affected classes. Because the members of a class are not likely to vote for a plan opposed by the committee representing that class,⁵² plan proponents almost invariably attempt to negotiate the endorsements of the committees. As will be explored further in Parts II and III, committees can sometimes employ the leverage they gain from their role in the reorganization

⁴⁶ See *id.* § 1126(d).

⁴⁷ See *id.* § 1129(a). Among the other statutory requirements is that each dissenting claimant receive under the plan at least as much as it would receive in a liquidation. See *id.* § 1129(a)(7)(A)(ii).

⁴⁸ The plan must be approved by at least one class of impaired creditors. See *id.* § 1129(a)(10). A class is not impaired if it receives cash equal to the amount of its claims or if the plan does not alter its contractual rights other than curing previous defaults. See *id.* § 1124. So long as the distributions proposed are in accord with the absolute priority rule, the plan is confirmable despite the opposition of all other creditors and shareholders. See *id.* § 1129(b).

⁴⁹ See *id.* § 1129(b).

⁵⁰ A corollary of the absolute priority rule, not expressly stated in the Code, is that classes senior to the dissenting class(es) should not receive more than full payment. See Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229, 231-32 (1990).

⁵¹ See LoPucki & Whitford, *Bargaining over Equity's Share*, *supra* note 16, at 137-41, 144.

⁵² Committee recommendations with respect to a proposed plan are frequently reported in the disclosure statement that is distributed before the vote.

plan approval process to influence management with respect to other issues of corporate governance.

B. *The Basic Conflicts in a Reorganization*

The process of corporate governance is, among other things, a process of conflict resolution. In this section, we examine the basic conflicts among managers, creditors, and shareholders that managers are commonly called upon to resolve. Three issues tend to predominate: (1) what levels of investment risk should the company seek while it determines whether or how to reorganize; (2) to what degree should the assets of the company be liquidated rather than reorganized; and (3) what mix of cash, debt and equity should be distributed and to whom?

1. Level of Risk in Investment Policy

Senior interests are often in sharp conflict with juniors as to the level of risk an insolvent company should accept in its investment policy.⁵³ To illustrate, assume that the value of a debtor's assets are equal to the amount of its liabilities, all of which are unsecured.⁵⁴ If the assets are preserved and invested conservatively during the reorganization case and distributions are then made in accord with the absolute priority rule, creditors will recover approximately the full amounts of their claims⁵⁵ and shareholders will recover little or nothing. If the assets are invested aggressively, they might increase or decline in value. If they decline, the shareholders will recover nothing and the creditors will receive less

⁵³ This basic creditor-shareholder conflict exists in all insolvency situations. For further exposition, see Jeremy I. Bulow & John B. Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437, 439-40 (1978); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 334-37 (1976); Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 335-36.

⁵⁴ The liabilities are assumed to be unsecured in order to avoid confusion between the vulnerability of secured and unsecured creditors discussed here and the vulnerability of secured creditors under the rule of *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371-73 (1988) (holding that secured creditors are not entitled to accrue or collect interest on undersecured claims).

⁵⁵ Assuming that the assets have the same value in liquidation as in reorganization, the creditors would be entitled to interest on their claims under the best interests of creditors test set forth in 11 U.S.C. § 1129(a)(7) (1988) because they could recover that interest if the debtor were liquidated under chapter 7. *See id.* § 726(a)(5). The proceeds of a conservative investment policy would probably be the approximate amount of that interest, so the proceeds essentially would go to creditors.

than they would have if the assets had been invested conservatively. If the assets increase in value, the creditors will still recover only the full amounts of their claims, while the benefit of the increase accrues to shareholders. It can thus be seen that when a marginally solvent company engages in high risk investment, the risks are borne primarily by creditors⁵⁶ while the benefits accrue primarily to shareholders.

This splitting of the risk of loss and the prospect of gain has profound implications for corporate governance of insolvent and marginally solvent companies. It will be referred to repeatedly throughout this Article. At this point, it is sufficient to observe that under certain commonly occurring circumstances, the holders of junior interests will have reason to prefer that the company engage in high risk investments while the holders of senior claims have reason to prefer the opposite policy.

When free from the control of creditors and shareholders, managers who wish to retain their jobs⁵⁷ might have reason to take either side in this conflict. A manager tainted by the company's financial problems might prefer to take high risks because only they could lead to returns sufficiently high to restore the manager to favor. On the other hand, a manager whose job and company are not in immediate jeopardy might prefer investments with risks that are lower than those preferred by the company's investors.⁵⁸

⁵⁶ Holders of shares that would be entitled to no distribution under a strict application of the absolute priority rule often are able to negotiate a share of a chapter 11 distribution. See *infra* note 61. Consequently they have something to lose. In most circumstances, however, they risk little because deviations in favor of shareholders from the absolute priority rule in the reorganization cases of large, publicly held companies are relatively small. See LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 142 tbl. III.

⁵⁷ Economic models often equate avoiding liquidation of the company with the manager's retaining of his or her job. See, e.g., Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 282 (1991) (employing a model equating liquidation with "financial ruin"). Our empirical finding that CEO job loss is common even in successful reorganizations, see *infra* Table IV accompanying note 190, leads us to place more weight on the possibility that the CEO may come to ruin even when the company does not.

⁵⁸ See John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 16-24 (1986); Rose-Ackerman, *supra* note 57 at 286-92.

2. Reorganization Versus Liquidation

Management often has a career interest in preserving the company. If the company is sold off, either in small parts or as a unit, the managers are likely to lose their jobs.⁵⁹ Reorganization under their continued management is sometimes the managers' only means of salvaging their reputations and careers. But it is important to realize that not all managers of reorganizing companies have these concerns. For example, some of the managers of the companies we studied were hired after the company was in severe difficulty for the express purpose of liquidating it.⁶⁰ Whether it is in the interests of management to liquidate or reorganize will depend on the circumstances.

The holders of underwater⁶¹ claims and interests often have reason to oppose liquidation until the distributions to them under a reorganization plan have been fixed. Such holders derive at least part of their bargaining leverage in plan negotiations from their ability to dispute the value of the assets continued in their current use, and therefore the value of the reorganization securities that would be issued if the company were reorganized rather than liquidated. Even if market values are available, parties in interest are permitted to argue that they are incorrect.⁶² But this leverage

⁵⁹ In nine of ten cases in our study in which the assets of the company were sold as a unit, the purchasers immediately installed their own CEOs. See *infra* Table V accompanying note 203. Only in the McLouth Steel case did a CEO's tenure in office continue after a sale of the business. During the McLouth case, the secured creditors forced the retirement of Gene E. Gann as CEO; Milton Deaner replaced him. Later, the debtor sold substantially all of the assets, primarily steel mills, to Tang Industries. Tang operated them as a subsidiary; Deaner continued as CEO of that subsidiary.

⁶⁰ See *infra* note 172.

⁶¹ We use the colloquial term "underwater" to refer to claims or interests in the debtor corporation that would be entitled to nothing if the assets of the company, valued at their liquidation or reorganization values, were distributed in accord with the absolute priority rule. We avoid reference to such claims or interests as "worthless" because they are not. Underwater claims retain resale value during the reorganization case because they usually share in the distributions under the plan. See JULIAN R. FRANKS & WALTER N. TOROUS, HOW FIRMS FARE IN WORKOUTS AND CHAPTER 11 REORGANIZATIONS 15 (John E. Anderson Graduate Sch. of Management at UCLA No. 1-91, 1991) ("[A]ll firms in our Chapter 11 sample experience deviations from the rules of absolute priority."); LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 141-42, 166 (reporting deviations from the absolute priority rule in favor of equity in 29 of 43 cases (67%)); Brian L. Betker, *An Analysis of the Returns to Stockholders and Bondholders in a Chapter 11 Reorganization* 4 (1991) (unpublished manuscript, on file with authors) (reporting deviations from the absolute priority rule in favor of equity in 42 of 65 cases (65%)).

⁶² See, e.g., *Citibank, N.A. v. Baer*, 651 F.2d 1341, 1347-48 (10th Cir. 1980) ("With

disappears to the extent that the values of assets are fixed through their liquidation during the case. Reflecting this change in leverage, in interviews we encountered the adage that "cash goes to creditors; [only] equity goes to equity."⁶³

This analysis does not mean that reorganization will be in the interests of the holders of junior claims and interests in every case. The holders may be so far underwater that they cannot win a share of the distribution; in that event, they will have no interest in what becomes of the company.⁶⁴ Nor does this analysis mean that the holders of senior claims will necessarily favor liquidation of the company. If the reorganization value of a grossly insolvent company is sufficiently in excess of its liquidation value,⁶⁵ it will be in the interests of the holders of senior claims to permit reorganization,

a newly reorganized company coming from the throes of bankruptcy, the actual market value of a share of stock may be considerably less than the pro rata portion of the going-concern value of the company represented by that stock.").

⁶³ In only two cases, Combustion Equipment and KDT, was anything other than common stock distributed to common stockholders. In those two cases, the distributions were nominal. The common stockholders in Combustion Equipment received \$315,000 in cash; the common stockholders in KDT received \$1,664,868 in cash. All values reported in this Table are present values as of the day after confirmation of the plan of reorganization. To the extent possible, we based them on actual trading values after confirmation. The methods by which we determined their present values are discussed in LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 135-36.

The amount of cash distributed to creditors in the cases we studied was more than a thousand times the amount distributed to shareholders. While a considerable amount of equity was distributed to creditors as well as equity holders, aside from the \$2 million in cash shown here, former equity holders received all of their distributions in new equity.

TABLE II
DISTRIBUTIONS TO CREDITORS AND SHAREHOLDERS
(in millions)

	Distributions made in cash	Distributions made in debt obligations	Distributions made in the equity of the emerging company
Total amount distributed to creditors in 43 cases	\$2513	\$3560	\$1691
Total amount distributed to common shareholders in 43 cases	\$2	\$0	\$917

⁶⁴ This possibility is discussed in LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 158-60.

⁶⁵ The possibility that the reorganization value of companies are never in excess of their liquidation values is considered *infra* notes 284-308 and accompanying text.

even at the price of permitting underwater claims and interests to share in the distribution, because seniors will be able to capture the bulk of the going-concern premium.

3. Nature and Beneficiaries of the Distributions

The most evident conflict of interest between different classes of creditors and shareholders concerns how much value each should receive in the distribution under the plan. In addition, there can be conflicts about whether the distributions that are made should consist of cash, debt, or equity. The distribution will usually consist of some combination of the three.

The various classes often differ as to the type of property they prefer to receive. Creditor classes tend to prefer distributions in cash or debt. If they receive a distribution in equity, many will quickly sell it,⁶⁶ and the sale may often be at a discount.⁶⁷ While most creditors probably prefer cash to debt, that preference appears to be especially strong among trade creditors.⁶⁸ The holders of underwater equity may believe they can win a bigger distribution if they accept equity.⁶⁹

Most managements can be expected to prefer that substantial portions of the distributions be made in equity. Cash distributions immediately deprive the company of liquidity. Though debt distributions may help a company reduce its future tax liability, they fix a claim against the company that may later threaten the managers' jobs.⁷⁰ Managers who want to stay in office will want

⁶⁶ Banks may be required to sell the equity interests they receive. *See infra* note 168 and accompanying text. Investors who receive stock for bonds may choose to sell because the stock does not fit their portfolio. Trade creditors are often compelled to sell by their financial circumstances.

⁶⁷ Several of our interviewees referred to the "dumping" of reorganization shares in the period following confirmation of the plan, with the implication that this dumping depressed prices.

⁶⁸ In the Revere Copper & Brass case, the confirmed plan of reorganization offered unsecured creditors a choice between payment in full over time with interest at 14%, and immediate payment of about 60 to 65 cents on the dollar in cash. Interviewees reported that institutional lenders generally opted for full payment with interest while the trade creditors preferred the cash option.

⁶⁹ *See supra* notes 62-63 and accompanying text.

⁷⁰ *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 67 ("[T]he violation of debt covenants creates a board-level crisis that brings new actors onto the scene, motivates a fresh review of top management and strategy, and accelerates response.").

to ensure that the company emerges from reorganization with no more than a manageable level of debt.

C. Other Studies

Major revisions of the laws governing the procedures for reorganization were made in 1939 and 1979. The relevance of the findings from particular studies to the issues discussed in this Article depends both on the period to which the study relates and the sizes of the companies studied.

1. Since 1979

For many years after the Bankruptcy Code became effective in 1979, there were no empirical studies of corporate governance in the bankruptcy reorganization of large, publicly held companies. In the past few years, however, there has been a flurry of activity, primarily among finance scholars. A number of these studies bear on particular aspects of this study, and they are cited as we discuss those aspects.

Several empirical studies have addressed issues of corporate governance in the context of the bankruptcy reorganization of smaller companies.⁷¹ Those studies found that management is normally the dominant party in a chapter 11 reorganization and uses its power to retain ownership of the company in disregard of the absolute priority rule. One reason is that with little at stake, the unsecured creditors of smaller companies often fail to participate in the case. If there is a creditors' committee at all, it rarely manages to engage management in negotiations or exercise significant control.⁷² A second reason managers are able to

⁷¹ See EXECUTIVE OFFICE FOR U.S. TRUSTEES, U.S. DEP'T OF JUSTICE, AN EVALUATION OF THE U.S. TRUSTEE PILOT PROGRAM FOR BANKRUPTCY ADMINISTRATION 39-87 (1983) [hereinafter ABT STUDY]; Jerome R. Kerkman, *The Debtor in Full Control: A Case For Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 160-65 (1987). See generally Lynn M. LoPucki, *The Debtor in Full Control—System Failure Under Chapter 11 of the Bankruptcy Code?* (pts. 1 & 2), 57 AM. BANKR. L.J. 99, 247 (1983) (reporting on an empirical study focusing on the effects of the 1979 changes in bankruptcy reorganization processes).

⁷² See ABT STUDY, *supra* note 71, at 58; LoPucki, *supra* note 71, at 249-53. Both of these studies were completed before 1986, when Congress extended the U.S. Trustee system to all bankruptcy districts. While that change has made some difference in the ability of management to act in an unfettered manner in chapter 11 proceedings, we doubt that it causes any change in the fundamental conclusions about how smaller chapter 11 reorganizations proceed.

dominate small cases is that for various reasons, the companies depend on the managers for their survival.⁷³ When these managers are also shareholders, they can often demand creditor acquiescence in a plan distributing value to equity—in violation of the absolute priority rule—as their price for remaining with the company.⁷⁴

There are several reasons to expect that the managers of large, publicly held companies will have less power and use it for different ends. Because the stakes are higher, creditors are more likely to organize committees and participate actively in the case. In fact, the committees nearly always engage management in intense negotiations. Secondly, it is less likely that continuance of particular managers in office will be critical to the success of a large, reorganizing company. For example, relations with key suppliers and customers are not so likely to depend on the continued presence of a single individual. Finally, while the managers of the companies we studied commonly owned some shares, in all but a few cases,⁷⁵ they were only a small percentage of the total shares outstanding. So even if it is desirable to retain management, from the creditors' perspective it is cheaper to reward them by providing advantageous employment contracts than by providing a distribution to the entire shareholder class. If management seeks to use its leverage to reward itself, it may well discover that the easiest avenue to that end is to ally with creditors and exact its price in the form of compensation.⁷⁶

⁷³ For example, key suppliers or customers may have strong personal relationships with the incumbent managers. If those managers leave, the suppliers or customers may go with them.

⁷⁴ This point was made years ago in Harry G. Guthmann, *Absolute Priority in Reorganization: Some Defects in a Supreme Court Doctrine*, 45 COLUM. L. REV. 739, 741-44 (1945). The only practical alternative for creditors if management leaves may be immediate liquidation of the business. This alternative can leave creditors with even less than they are provided under the plan proposed by the managers.

⁷⁵ In four cases, Evans Products, Dresco Energy, Charter Company, and Continental Airlines, a single shareholder held a substantial block of shares and was active on the board of directors. The dynamic in these cases tended to be more like the dynamic in smaller reorganization cases. See *infra* note 242 and accompanying text.

⁷⁶ Gilson and Vetsuypens have found that in large cases, CEO compensation is sometimes tied explicitly to the creditor returns in chapter 11 proceedings, suggesting that sometimes it is through compensation, rather than distributions under the plan, that senior interests forge alliances with management. See Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis* 21 (Sept. 1992) (unpublished manuscript, on file with authors); see also LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 151 n.54;

2. Between 1939 and 1979

During this period, the statutory framework for corporate reorganization in bankruptcy was dramatically different. For publicly held companies, trustees were normally appointed, displacing managers from at least some of their functions. Partly for this reason, there were relatively few reorganization proceedings involving large, publicly held companies. And in any event, what occurred in those proceedings has little relevance to the corporate governance issues that are the focus of our study, because the statutory framework governing those proceedings was so different.⁷⁷

3. Before 1939

There are a number of studies of corporate reorganization from the pre-1939 period.⁷⁸ The largest and best known is the so-called *Douglas Report*, a multi-volume study conducted by the SEC under the direction of William O. Douglas.⁷⁹ This report focused

Betker, *supra* note 40, at 24 (“[U]pon leaving office, Manville’s chairman/CEO and president received \$1.8 million in severance pay. Manville’s officers and directors owned about .03% of the 24 million share[s] outstanding. The severance pay thus represented about \$250 dollars per share held by top management, yet equity holders received only about 90 cents per share in the reorganization.”).

⁷⁷ For empirical studies of bankruptcy reorganizations during this period, none of which focus on the questions addressed in this Article, see EDWARD I. ALTMAN, *CORPORATE BANKRUPTCY IN AMERICA passim* (1971); PHILIP B. NELSON, *CORPORATIONS IN CRISIS* 16-155 (1981); DAVID T. STANLEY & MARJORIE GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM passim* (1971); James S. Ang & Jess H. Chua, *Corporate Bankruptcy and Job Losses Among Top Level Managers*, FIN. MGMT., Winter 1981, at 70.

⁷⁸ For many years there were no reorganization provisions in the Bankruptcy Act itself. Corporate lawyers nonetheless devised a reorganization procedure, borrowing from the equity receivership. Typically in these proceedings management arranged to remain in control of the business during the period of reorganization. For succinct summaries of how reorganization proceedings built on the equity receivership worked, see Theodore Eisenberg, *Baseline Problems in Assessing Chapter 11*, 43 U. TORONTO L.J. (forthcoming 1993); E. Merrick Dodd, Jr., Note, *Reorganization Through Bankruptcy: A Remedy for What?*, 48 HARV. L. REV. 1100, 1102-10 (1935).

When reorganization procedures were added to the Bankruptcy Act in the 1930s, the same basic principle of management control was retained. Among empirical studies of pre-1939 reorganizations, the best known, other than the DOUGLAS REPORT discussed in this Article, is ARTHUR S. DEWING, *CORPORATE PROMOTIONS AND REORGANIZATIONS* (1914).

⁷⁹ See DOUGLAS REPORT, *supra* note 11. The Report was published in eight parts over a three year period. Congress had provided for the study in the Securities & Exchange Act of 1934. See Act of June 6, 1934, ch. 404, § 211, 48 Stat. 881, 909 (codified as 15 U.S.C. § 78jj) (repealed 1987).

centrally on the role of management in reorganization proceedings. The report found that management exerted a great deal of control over the proceeding, and that this power was frequently exercised in a self-serving manner. Management sought to preserve themselves in office, and in doing so frequently thwarted investigations into whether their own past behavior contributed to the corporation's financial distress. Another strong theme of the report was that executives, perhaps in alliance with a few powerful creditors such as commercial banks, were often able to control the committees that represented various claimants in the reorganization. This power was sometimes exercised to the particular disadvantage of public security holders, who found it difficult to challenge the fairness of a proposed plan of reorganization supported by management and the committees representing creditors and shareholders.⁸⁰

There are important differences between the pre-1939 statutory scheme and the current Bankruptcy Code. Most importantly, in assigning to the U.S. Trustee the power to appoint committees,⁸¹ the current statute attempts to insure that management has little influence over their composition. Nonetheless, the question of whether the diagnoses of the *Douglas Report* apply today remains an important one for our study.⁸²

⁸⁰ The *Douglas Report* itself is voluminous, but one of the eight reports contains a summary of the essential findings. See DOUGLAS REPORT, *supra* note 11, at pt. 8. There are several contemporaneous commentaries which summarize the essential findings, of which probably the best is E. Merrick Dodd, Jr., *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM. L. REV. 223 *passim* (1938); see also John W. Hopkirk, *William O. Douglas—His Work in Policing Bankruptcy Proceedings*, 18 VAND. L. REV. 663, 666-84 (1965) (studying Douglas's work in the field of bankruptcy and corporate reorganization).

⁸¹ See 11 U.S.C. § 1102(a) (1988).

⁸² We are not implying our agreement with the criticisms that the *Douglas Report* made of the 1930s bankruptcy reorganization system. For our purposes, we consider the conclusions of the *Douglas Report* as hypotheses in our study of current reorganization practice. For a contemporaneous criticism of the *Douglas Report*, see Robert T. Swaine, "Democratization" of Corporate Reorganizations, 38 COLUM. L. REV. 256, 259 (1938) ("[T]he [Douglas] Reports fall materially short of the standards imposed by the Securities Act of 1933 upon security underwriters."). Interestingly, Swaine anticipated reasons commonly given for the 1979 reforms. In particular, he was concerned that displacement of management by a court-appointed trustee and the requirement that all reorganization plans be approved by a court as fair and equitable would cause undue delay.

II. THE FOUNDATIONS OF MANAGEMENT POWER

In Part I, we noted that management of the debtor corporation routinely remains in office after filing and has considerable power over both the business plan and the reorganization plan. In this part, we explore these sources of power further and examine the means by which creditors and shareholders can influence or compel management to exercise this power in desired ways. In a short concluding section, we emphasize the potentially important role of the bankruptcy judge in determining the practical extent of management power and the manner of its exercise. We present findings from our empirical study where relevant.

A. *Management's Power of Initiative*

1. The Business Plan

Management's most fundamental power is its exclusive right to initiate the business and reorganization plans. This power is most complete with respect to the business plan. There is no legal requirement that the business plan, as such, be approved by the court or even revealed to creditors or shareholders. Management may simply go about planning the business transactions needed—such as the sale or closing of particular units, reductions in the numbers of employees, or institution of new competitive strategies—much as they would in the absence of bankruptcy.

When the transactions necessary to carry out the business plan are not “in the ordinary course of business,” creditors and shareholders have the right to notice and a hearing before management can commit the company.⁸³ Examples of the transactions for which prior notice must be given include: sales of assets outside the ordinary course of business, borrowing money outside the ordinary course of business,⁸⁴ and the rejection of any executory contract existing at the time of filing.⁸⁵ There are no explicit statutory standards to guide courts when they decide whether to approve proposed management actions. Generally, however, the courts give considerable deference to management's “business judgment.”⁸⁶

⁸³ See 11 U.S.C. § 363(b) (1988).

⁸⁴ See *id.* § 364(b).

⁸⁵ See *id.* § 365(a).

⁸⁶ See *infra* note 138 and accompanying text.

While other parties in interest can make suggestions and exert pressure, only management can initiate the transactions that constitute the business plan. As long as management remains in office, they can prevent implementation of an unwanted business plan.⁸⁷

2. The Reorganization Plan

Neither management nor the debtor are entitled to vote on a plan of reorganization. The debtor, however, does have the exclusive right to propose a plan during the first 120 days of the reorganization case, and such extensions of that time as the court may grant for cause.⁸⁸ The bankruptcy judge extended exclusivity for the duration of the reorganization case for thirty-four of the forty-three companies we studied.⁸⁹ Only in the remaining nine cases did creditors or shareholders ever have the opportunity to file and seek confirmation of a plan not agreed to by management.⁹⁰

So long as management retains the exclusive right to file a plan, the process of plan proposal and approval goes forward only at a time and on terms acceptable to management. Management's

⁸⁷ See Frost, *supra* note 10, at 129 (“[A]lthough judicial review of particular decisions provides some degree of control over managerial conduct when the conduct is affirmative, the system may not address management’s failure to act.”). Perhaps the sole exception is that if management’s exclusive right to file a reorganization plan is terminated, other parties could propose and adopt a reorganization plan that mandated a particular business plan. But as we discuss further in the next section, exclusivity is seldom terminated in the cases of large, publicly held companies.

⁸⁸ See 11 U.S.C. § 1121 (1988). The court can also reduce the exclusivity period to less than 120 days, *see id.* § 1121(d), but that never happens in large cases.

⁸⁹ See Table III, *infra* note 177.

⁹⁰ See Table III, *infra* note 177. These findings seem to us to be at variance with the concern expressed by a leading practitioner that the bankruptcy courts are “eroding” management’s bargaining leverage in a chapter 11 by not extending this exclusive authority routinely. See Harvey R. Miller & Jacqueline Marcus, *The Crumbling Debtor Leverage in Chapter 11 Cases—An Implementation or Perversion of the Bankruptcy Reform Act of 1978*, in ALI-ABA COMM. ON CONTINUING PROFESSIONAL EDUC., THE WILLIAMSBURG CONFERENCE ON BANKRUPTCY: CRITIQUE OF THE FIRST DECADE UNDER THE BANKRUPTCY CODE AND AGENDA FOR REFORM 447, 472, 469-81 (1988) [hereinafter ALI-ABA, CRITIQUE] (“[T]he evolving case law indicates a growing rate of erosion of the debtor’s maintenance of exclusivity as to plan proposal.”). The principal variable correlating with the removal of exclusivity in our study was not the number of years over which the case proceeded but the venue of the case. In most jurisdictions, including the important one of the Southern District of New York, exclusivity is almost always maintained for the duration of the reorganization of a large, publicly held company. See LoPucki & Whitford, *Venue Choice*, *supra* note 16, at 30-32 & n.67.

ability to delay reorganization by not proposing a plan usually provides considerable leverage in plan negotiations. Delay imposes costs on creditors. First, while the case remains pending, the debtor is required to make only adequate protection payments to secured creditors, and is rarely permitted to make any payments to unsecured creditors. Second, creditors usually bear risk of loss from continuing business operations while the case remains open that is out of proportion to their possibility of gain.⁹¹

3. Management's Information Advantage

Management also gains considerable power by being better informed than other interested parties. Management sees information on the performance of the business first, is able to devote more time to the company, and has direct access to and control over the company employees who generate the information.

B. *Creditor and Shareholder Power to Control Management*

1. Shareholders' Ability to Remove Management

Absent bankruptcy, the managers of a corporation are appointed to their offices by the board of directors. Though it might breach an employment contract to do so, the board of directors is always free to remove managers. Similarly, shareholders have the unfettered right to remove directors from office. In theory, they do this by casting their votes at a meeting of shareholders. In practice, they do it by means of a proxy fight, or, as has become more common in recent decades, acquiring a controlling block of shares through a tender offer.

The machinery of corporate democracy is cumbersome, and serious questions have been raised about its effectiveness in enabling shareholders to compel management to serve shareholders' interests.⁹² But whether or not shareholders can make effective

⁹¹ See *supra* notes 53-58 and accompanying text.

⁹² See, e.g., ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 277 (1932) ("[T]he shareholder in the modern corporate situation has surrendered a set of definite rights for a set of indefinite expectations."); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1443 (1985) ("The prevailing structure of corporate governance gives corporate management substantial discretion to reward itself . . ."). But see Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 387 (1983) ("[W]hen the need arises, dispersed ownership will become

use of their right to control management, in the financially healthy corporation there seems to be no doubt that the right exists.

Once the corporation has become insolvent and filed for reorganization, the shareholders' right to control the corporation through voting becomes problematic. While the courts continue to recite that "the right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings,"⁹³ they add that the right may be enjoined in cases of "clear abuse." What constitutes "clear abuse" is not clear.⁹⁴

sufficiently concentrated to give proper guidance to, perhaps to 'boot' out, an ineffective management."); J.A.C. Hetherington, *Redefining the Task of Corporation Law*, 19 U.S.F. L. REV. 229, 236 (1985) ("Critics of all shades of opinion concerning the modern business corporation would agree that, separation of ownership or not, managements of publicly held corporations have in fact continued to strive to increase corporate profits.").

⁹³ *Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 801 F.2d 60, 64 (2d Cir. 1986) (citing *Van Siclén v. Bush (In re Bush Terminal Co.)*, 78 F.2d 662, 664 (2d Cir. 1935)); see, e.g., *In re Harper Indus., Inc.*, 18 B.R. 773, 775 (Bankr. S.D. Ohio 1982) ("Replacement of management remains the prerogative of the Board of Directors (and ultimately the stockholders), and unless impeded by a court order initiated by action of its creditors . . . the Board is free to exercise that prerogative."); *Saxon Indus., Inc. v. NKFV Partners*, 488 A.2d 1298, 1300 (Del. 1984) ("[A]bsent other compelling legal or equitable factors, insolvency alone, irrespective of degree, does not divest the stockholders of a Delaware corporation of their right to exercise the powers of corporate democracy.").

⁹⁴ The leading contemporary case is *In re Johns-Manville Corp.*, 801 F.2d 60. On remand, the bankruptcy court enjoined the shareholder meeting in that case. See *Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 66 B.R. 517, 541-42 (Bankr. S.D.N.Y. 1986). The clear abuse standard pre-dates adoption of the 1979 Code. See *Haugh v. Industries, Inc. (In re Public Serv. Holding Corp.)*, 141 F.2d 425 (2d Cir. 1944) (decided under repealed Chapter X); *In re J.P. Linahan, Inc.*, 111 F.2d 590, 592 (2d Cir. 1940) ("[T]he right of the majority of stockholders to be represented by directors of their own choice . . . is paramount and will not be disturbed unless a clear case of abuse is made out."); *Alrac Corp. v. Clement (In re Alrac Corp.)*, 1 Bankr. Ct. Dec. (CRR) 1504 (Bankr. D. Conn. 1975). A number of recent articles discuss this question. See Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, Or Should the Meeting Be Canceled Altogether?*, 58 GEO. WASH. L. REV. 1214, 1246 (1990) (noting that "[s]everal courts have denied shareholder meeting requests upon finding that the meeting would constitute a clear case of abuse of the traditional shareholder-director relationship"); Anna Y. Chou, *Corporate Governance in Chapter 11: Electing A New Board*, 65 AM. BANKR. L.J. 559, 560-89 (1991) (analyzing case law dealing with post-bankruptcy shareholder election rights); Michael A. Gerber, *The Election of Directors and Chapter 11—The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 BROOK. L. REV. 295, 321 (1987) (recognizing the courts' reluctance to suspend corporate governance in pre-Code cases); Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 60-64 (1989) (discussing the treatment of "clear abuse").

The case law generally attempts to distinguish cases in which the shareholders seek to replace management in order to improve their leverage in bargaining, which is not considered abuse, from cases in which the shareholders' attempt to replace management threatens the success of the reorganization, which is considered abuse.⁹⁵

The distinction has not been easy to draw. In *In re Johns-Manville*, the bankruptcy court enjoined shareholders from calling a meeting of shareholders for the stated purpose of installing new management that would seek a better deal for shareholders.⁹⁶ The court concluded that new management with a mandate to drive a harder bargain on behalf of shareholders would find it impossible to obtain the agreement of creditors. The effect of trying, according to the court, would have been further delay and, if new management refused ultimately to accept the deal already offered by creditors, possible failure of the reorganization and liquidation of the company. On that basis, the court enjoined the meeting.⁹⁷ The decision is a controversial one, and strongly worded arguments have been made that shareholders should have been able to hold their meeting.⁹⁸

A lone footnote in a Second Circuit opinion in *Manville* strongly implied that the shareholders' purpose in seeking to oust management mattered only in the cases of solvent debtors. In the far more common cases of insolvent reorganizing debtors, "denial of the right to call a meeting would likely be proper [in every case], because the shareholders would no longer be real parties in interest."⁹⁹ The footnote is dicta, because at the time it was assumed that the *Manville* company was solvent. However, it suggests that shareholders of the large majority of reorganizing companies should not be able to meet in any circumstances.

Among the four cases in our study where the matter was contested, shareholders were denied the right to hold meetings as often as they were permitted to hold them. In the FSC Corporation case, the CEO of a grossly insolvent company¹⁰⁰ had become a

⁹⁵ See *In re Johns-Manville Corp.*, 801 F.2d at 64-67; *In re Potter Instruments Co.*, 593 F.2d 470, 475 (2d Cir. 1979).

⁹⁶ See *Manville Corp. v. Equity Sec. Holders Comm.* (*In re Johns-Manville Corp.*), 66 B.R. 517, 542 (Bankr. S.D.N.Y. 1986).

⁹⁷ See *id.* at 536-42.

⁹⁸ See Budnitz, *supra* note 94, at 1262-63; Gerber, *supra* note 94, at 337-56.

⁹⁹ *In re Johns-Manville Corp.*, 801 F.2d at 65 n.6.

¹⁰⁰ The creditors in FSC recovered an average of only 37.6 cents on the dollar. See LoPucki & Whitford, *Bargaining for Equity's Share*, *supra* note 16, at 142. Though

bitter adversary of an investor group that owned nearly fifty percent of the stock.¹⁰¹ In an unreported decision, the bankruptcy court enjoined a meeting of shareholders at which the controlling investor group intended to elect new directors who would remove the CEO. The court refused to allow the meeting because it would have cost as much as \$60,000 and would not have been "in the best interests of the estate."¹⁰² The CEO remained in control of the company for the duration of the case. Under his stewardship, the company proposed and obtained confirmation of a plan that shifted voting control to the creditors. The CEO continued in office after confirmation.

In two other cases from our study, Lionel Corporation¹⁰³ and Saxon Industries,¹⁰⁴ attempts to enjoin shareholders from calling a meeting to elect new directors were rejected by the courts.¹⁰⁵ By our valuation protocols, Saxon was grossly insolvent, while Lionel was marginally solvent.¹⁰⁶ A state court in *Saxon* expressly stated that the right to meet was not dependent on solvency;¹⁰⁷

we have no direct evidence that the solvency of the company played any role in the court's decision, we assume that it did.

¹⁰¹ Prior to reorganization, the investor group sold its controlling interest in the company to a group of buyers. In accord with the sale contract, the investor group's officers and directors resigned from office. After the buyer group's officers and directors had been in office for about a week, the buyers announced a rescission of the sale and also resigned from office. The investor group refused the rescission and, consistent with that position, refused to reassume their offices. During this period in which the company de facto had no officers or directors, creditors petitioned the company into involuntary bankruptcy. The bankruptcy court appointed a long time employee of the company as CEO. When the original investor group later accepted rescission of the contract for sale and sought to reassert control over the company, the CEO resisted. There resulted the litigation in which the investors were denied the opportunity to hold a shareholders' meeting for the purpose of removing the CEO. See *infra* text accompanying note 102.

¹⁰² This decision is mentioned by the court in a later opinion. See *In re* FSC Corp., 38 B.R. 346, 348 (Bankr. W.D. Pa. 1983).

¹⁰³ See *Lionel Corp. v. Committee of Equity Sec. Holders (In re Lionel Corp.)*, 30 B.R. 327 (Bankr. S.D.N.Y. 1983).

¹⁰⁴ See *In re* Saxon Indus., 39 B.R. 49 (Bankr. S.D.N.Y. 1984); *Saxon Indus., Inc. v. NKF Partners*, 488 A.2d 1298 (Del. 1984).

¹⁰⁵ The same result occurred in another large case in which a plan was confirmed too recently to be included in our study. See *In re Allegheny Int'l, Inc.*, [1987-89 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 72,328 (W.D. Pa. 1988).

¹⁰⁶ See *LoPucki & Whitford, Bargaining Over Equity's Share, supra* note 16, at 142, 166.

¹⁰⁷ See *Saxon Indus., Inc. v. NKF Partners*, 488 A.2d at 1300 (holding that insolvency alone did not "divest the stockholders of a Delaware corporation of their right to exercise the powers of corporate democracy"). The bankruptcy court had earlier refused to enjoin the prosecution of the Delaware Court proceeding seeking

the bankruptcy court did not address the issue in either case. In both cases, once it was clear that the shareholders could meet and vote, the shareholders were able to reach agreement with management on terms that substantially improved their treatment under the reorganization plan. In neither case was the meeting of shareholders actually held. Since the period covered by our study, two more courts have discussed the right of shareholders to meet during chapter 11, but neither opinion directly addresses the points we discuss here.¹⁰⁸

This line of cases makes the ability of shareholders of a reorganizing company to hold a meeting to replace management highly problematic. That complication makes hostile takeover of a reorganizing company by purchasing a controlling block of shares during the case impractical. Unless they could persuade the court to issue a declaratory opinion, investors interested in control would have to purchase the shares before they could learn whether they could use the acquired shares to replace incumbent management. Few are likely to take that risk.¹⁰⁹ Since the threat of hostile takeover will be reduced during reorganization, management's position may be more secure, making reorganization more attractive to them.

a shareholder meeting, even though Saxon was clearly insolvent. See *In re Saxon Indus.*, 39 B.R. at 50.

¹⁰⁸ See *In re Heck's, Inc.*, 112 B.R. 775 (Bankr. S.D. W. Va. 1990) (opining that once management proposes a plan that would extinguish equity interests, it is a clear abuse for equity holders to attempt to meet); *In re Allegheny Int'l, Inc.*, [1987-89 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 72,328 (W.D. Pa. 1988) (reversing an unpublished bankruptcy court order which had enjoined shareholders from meeting).

¹⁰⁹ On the other hand, friendly takeovers of companies in chapter 11 are reasonably common. Typically, the outside investor agrees to provide the financing necessary to fund a reorganization plan in return for a control block of shares under the reorganization plan. Once such a deal is made, the board of directors of the debtor corporation, perhaps as a condition of the agreement, often appoints the investor's nominees as management even before the plan approval process is completed. In our study, there were several companies that followed this pattern, such as Cook-United, Inc.

Investors recently attempted the hostile takeover of a corporation in chapter 11 by acquiring claims, not shares. See *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 286-87 (Bankr. W.D. Pa. 1990) (outlining a claim purchase plan as part of a hostile takeover strategy). If enough claims are acquired, the investor can ensure that after confirmation it will control the company by receiving a majority of the shares for its acquired claims. Takeover does not occur, however, until after confirmation of a plan. See Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 13-25 (1990); Herbert P. Minkel, Jr. & Cynthia A. Baker, *Claims and Control in Chapter 11 Cases: A Call for Neutrality*, 13 CARDOZO L. REV. 35, 74-101 (1991).

Although there are fewer cases, it seems clear that the bankruptcy court has the power to prevent a board of directors from replacing management that is analogous to its power to prevent shareholders from replacing the board.¹¹⁰ We doubt that a court would prevent a board from removing a manager that the board reasonably considered incompetent.¹¹¹ Still, the potential inability of a board to replace management is another impediment to shareholder control of management through corporate governance processes.

2. Creditors' Ability to Remove Management

Even if a court denies shareholders the right to elect directors because creditors are the real parties in interest, no mechanism exists by which the creditors can themselves elect directors. The formal method for creditors to bring about a change in management is to move for appointment of a trustee. Although the Code appears to vest considerable discretion in the court to appoint trustees,¹¹² in practice the appointment of a trustee is regarded by the bankruptcy courts as an extraordinary remedy to be employed reluctantly.¹¹³

Trustees were appointed in only two of the forty-three cases in our study (five percent).¹¹⁴ Both appointments were at the request of creditors. In three other cases, the court appointed persons who functioned essentially as trustees, without that title.¹¹⁵ We refer to these appointees as "quasi-trustees." If they

¹¹⁰ See *In re Gaslight Club, Inc.*, 782 F.2d 767, 770 (7th Cir. 1986) ("The case law demonstrates that the court has considerable authority to interfere with the management of a debtor corporation in order to protect the creditors' interests."); *In re United Press Int'l, Inc.*, 60 B.R. 265, 272-73 (Bankr. D.C. 1986).

¹¹¹ Precisely this happened many times in the cases we studied, without any effort by any party to resort to the "clear abuse" standard to prevent the removal.

¹¹² See 11 U.S.C. § 1104(a) (1988).

¹¹³ See, e.g., *In re Microwave Prods. of America, Inc.*, 102 B.R. 666, 670 (Bankr. W.D. Tenn. 1989) ("The appointment of a trustee is the exception rather than the rule in chapter 11 cases, and is an extraordinary remedy available to creditors."); *In re Tyler*, 18 B.R. 574, 577 (Bankr. S.D. Fla. 1982) ("All of the authorities agree that the appointment of a trustee under § 1104 is an extraordinary remedy."); see also Nimmer & Feinberg, *supra* note 94, at 54-60 (offering an extensive discussion of the relevant case law).

¹¹⁴ The cases were *Sambo's Restaurants and NuCorp*.

¹¹⁵ In the *Pizza Time Theatre* case, creditors moved for appointment of a trustee. Before the motion was ruled upon, the board of directors consented to the appointment as CEO of a specific person nominated by the creditors, and to a court order stripping the board of its ability to remove that person from office.

are included, the proportion of cases in which management was displaced by a trustee is about twelve percent. It then is apparent that the appointment of trustees plays a greater role in these cases than it does in small reorganization cases.¹¹⁶

During the period of our study, the persons who filled the office of trustee were formally selected by the bankruptcy court in some districts and by the office of the U.S. Trustee in others.¹¹⁷ Under either system, parties in interest could sometimes exert influence by nominating or supporting candidates for trustee.¹¹⁸ Once appointed, a trustee "is a fiduciary who has an obligation to treat all parties in a reorganization case fairly."¹¹⁹ Nevertheless, in the cases we studied there was a clear tendency for trustees to be seen by the parties in the case as exercising their discretion against underwater claims and interests and in favor of more senior claims.¹²⁰ Partly for that reason, the holders of junior claims and interests rarely seek the appointment of a trustee.

In the EPIC case, the incumbent management resigned at filing because it was implicated in fraud. The board of directors was controlled by the debtor's only shareholder, who was also a major creditor. Because of this conflict, the board asked the bankruptcy court to appoint an attorney for the debtor. In negotiations over the business and reorganization plans, the attorney functioned essentially as a trustee.

Shortly before the filing of an involuntary bankruptcy case against FSC Corporation, management and the board resigned en masse. The bankruptcy court appointed a vice-president to be CEO, and enjoined the shareholders from electing a new board.

¹¹⁶ In an earlier study of the reorganization of small companies, LoPucki found that trustees were appointed in about 10% of the cases. See LoPucki, *supra* note 71, at 124-25. But direct comparison of that figure with the rate reported here overstates the importance of trustees in small reorganization cases. Nearly all of the appointments in the small cases came only after the debtor had abandoned its efforts to reorganize; the trustees so appointed quickly converted the cases to chapter 7. See *id.*

¹¹⁷ In 1986, the U.S. Trustee program was extended nationwide. See Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 226, 100 Stat. 3088, 3102-03. Currently, all chapter 11 trustees are selected formally by the office of the U.S. Trustee. See 11 U.S.C. § 1163 (1988).

¹¹⁸ For example, the trustee appointed in Nucorp was suggested by the secured creditors; the quasi-trustee appointed in Pizza Time Theatre was chosen by creditors and "introduced" to the board.

¹¹⁹ 5 COLLIER ON BANKRUPTCY ¶ 1106.01(2)(b) (Lawrence P. King ed., 15th ed. 1992).

¹²⁰ Both trustees, and two of the three quasi-trustees, came to be perceived as strong advocates of creditors, or particular groups of creditors. Though considered neutral at the time of his appointment, the trustee in Nucorp came to be regarded by the unsecured creditors as a close ally of the secured creditors. Shortly after his appointment, the trustee in Sambo's closed the business and proposed a plan that

Incumbent managers also have good reason to fear the appointment of a trustee. The appointment necessarily means that their power will be limited, even if they continue to be in charge of day-to-day operations. As a result, a creditor's threat to seek appointment of a trustee, or an examiner,¹²¹ can be a powerful leverage device. To avoid even a small chance that a trustee or examiner may be appointed, managers may be willing to make substantial concessions to creditors.¹²²

3. Withdrawal of Credit

In nearly all of the cases studied, the debtor had an ongoing relationship with a group of institutional lenders that supplied the bulk of its credit needs. The agreement between the debtor and these primary lenders generally provided that, in the event of default,¹²³ the lenders had the right to declare their entire debts

strictly adhered to the absolute priority rule. The effect was to zero out shareholders. The quasi-trustee in FSC openly battled against the efforts of shareholders to regain control of the company. The quasi-trustee in Pizza Time Theatre was actually selected by creditors and "introduced" to the board of directors. The only trustee or quasi-trustee to advocate for underwater claims or interests was the quasi-trustee in EPIC. He advocated making a modest distribution to limited partners whose equity interests were clearly underwater. In an exception to the general tendency for trustees and quasi-trustees to take the side of seniors against juniors, the trustee who zeroed out the shareholders in Sambo's then battled tenaciously to force the compromise of priority claims against the estate, and thereby increase the recovery of general unsecured creditors.

¹²¹ Section 1104(b)(2) permits the court, on motion of a party in interest, to appoint an "examiner" to inquire into management's past behavior. See 11 U.S.C. § 1104(b)(2) (1988). One purpose for appointment of an examiner can be to help the court determine whether appointment of a trustee is appropriate. The statute has been interpreted to require the court in large cases to appoint an examiner upon request of a creditor. See *id.* ("[O]n request of a party in interest . . . the court shall order the appointment of an examiner . . . if . . . the debtor's fixed, liquidated, unsecured debts . . . exceed \$5,000,000.") (emphasis added); *In re Revco D.S., Inc.*, 898 F.2d 498, 500-01 (6th Cir. 1990). Examiners were appointed in a few of our cases, but never was the appointment of an examiner followed by appointment of a trustee. Often a principal function of the examiner was to recommend whether the debtor corporation should pursue a remedy against former management. But even on this topic, the examiners' recommendations were not followed in some of the cases. Except in the White Motor case, discussed *infra* note 122, examiners did not play important roles in the cases we studied.

¹²² For example, in White Motor, the appointment of an examiner led to the likelihood of the appointment of a trustee. That likelihood was sufficient to result in the resignation of the incumbent CEO. Similarly, under threat of the appointment of a trustee, the board of directors of Pizza Time Theatre consented to the appointment of a CEO of the creditors' choosing.

¹²³ Many, if not most, of the defaults by debtors in the cases studied were not

immediately due and payable. If the debtors did not pay, nonbankruptcy law and the credit contracts provided a variety of procedures the creditors could use to coerce payment through the forcible liquidation of assets. The procedures were often complex, cumbersome, and slow.¹²⁴ Nonetheless, in the absence of bankruptcy, the lenders' ability to withdraw the funds they had loaned to the debtor generally constituted a credible threat to the existence of a debtor's business and provided leverage sufficient to compel changes in corporate behavior.

Upon the filing of a bankruptcy case, creditors' rights to withdraw the money they have loaned are blocked initially by the automatic stay.¹²⁵ For unsecured creditors to obtain relief from the automatic stay during a reorganization case is virtually impossible.¹²⁶

But scholars who conclude that the automatic stay renders creditors helpless¹²⁷ overstate their point. Secured creditors have the right to relief from the automatic stay in some circumstances.¹²⁸ In some of the cases we studied, secured lenders were able

failures to pay when due. A large portion were failures to maintain financial ratios. Moreover, the contracts of many creditors contain covenants that the company will not default on any of its debts, coupled with acceleration clauses. If the company defaults on any of its obligations, it is likely that a large portion of its debt will immediately fall due. This will include obligations to holders of publicly held debt. Default on publicly held debt is particularly troublesome because of the difficulty of renegotiating the terms. See *Roe*, *supra* note 8, at 277.

¹²⁴ See LoPucki, *supra* note 53, at 315-21.

¹²⁵ See 11 U.S.C. § 362 (1988).

¹²⁶ See *id.* § 362(d). The expectation is that unsecured creditors will be paid only under the plan of reorganization.

¹²⁷ See, e.g., Bradley & Rosenzweig, *Untenable Case*, *supra* note 10, at 1076 ("The 1978 Act thus provides managers with . . . a way to keep control of the firm free from the intrusive monitoring of creditors . . .").

¹²⁸ Secured creditors have the right to reclaim their collateral if: (1) the collateral is not needed in the reorganization and the debtor does not have a realizable equity in it, or (2) the debtor fails to "adequately protect" the creditor against a decline in the value of the collateral during the reorganization case. See 11 U.S.C. § 362(d) (1988).

During most of the period covered by our study, the courts in the Ninth Circuit and some other jurisdictions interpreted the adequate protection requirement in a manner that often required payment of interest to secured creditors. See *Grundy Nat'l Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 1441 (4th Cir. 1985); *In re American Mariner Indus., Inc.*, 734 F.2d 426, 432 (9th Cir. 1984). Late in the period covered by our study, the Supreme Court rejected the Ninth Circuit's interpretation in *United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365 (1988), leaving secured creditors entitled to interest on their secured claims only to the extent that the value of their collateral exceeds the amount of their claims. *Timbers* substantially reduces the likelihood that a secured creditor can gain substantial

to generate considerable leverage from a credible threat to demand adequate protection for their collateral. Among the cases in our study, McLouth Steel provides the most dramatic example. In that case, the primary lenders had blanket liens on virtually all of the debtor's assets. Shortly after the filing of the case, the lenders moved to lift the automatic stay on the ground that the debtor was unable to provide them with adequate protection. Fearing that the stay would be lifted, the debtor entered into a settlement agreement that was so burdensome it effectively put the secured lenders in control of the company.¹²⁹

Even creditors who have no right to withdraw funds already lent may be able to obtain leverage through their ability to supply the debtor's credit needs during reorganization.¹³⁰ In ordinary circumstances, debtors and creditors often anticipate and rely on the future extension of additional credit.¹³¹ In the financial turmoil surrounding bankruptcy, the creditors who routinely supplied the company's credit needs prior to reorganization may be able to condition further supply on management's service of those creditors' special interests.

Not all debtors will be vulnerable to this kind of pressure. Under the protection of the automatic stay, some debtors can solve their immediate cash flow problems by suspending payments to unsecured creditors and limiting payments to secured creditors to the decline, if any, in the value of the secured creditors' collateral.¹³² Without that drain on cash flow, revenues from operations may be sufficient to sustain those operations. But if they are not,

leverage by means of a threat to lift the automatic stay for failure to provide adequate protection.

¹²⁹ Among other things, the agreement contained a "drop dead" provision, by which the debtor agreed to surrender the steel mills to the secured lenders if the debtor did not sell them by a date only a few months away. The secured lenders maintained their control by granting short extensions of the drop dead date.

¹³⁰ The Bankruptcy Code permits debtors to borrow money during reorganization and, with certain limitations, to grant new, postpetition lenders priority over prepetition creditors. See 11 U.S.C. § 364(c)-(d) (1988) (stating that prepetition creditors must be provided with "adequate protection"). Management's desire for new financing, together with an existing creditor's incentives to provide it, can provide each with leverage against the other. See George G. Triantis, *Relational Stakeholder Contracts in Bankruptcy*, 43 U. TORONTO L.J. (forthcoming 1993).

¹³¹ See, e.g., *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (holding that the implied obligation of good faith imposed on lender a duty to give notice to borrower before refusing to advance funds under financing agreement).

¹³² For secured creditors, whether interim payments are made depends on how adequate protection issues are resolved. See *supra* note 128.

the debtor must find the money elsewhere or face immediate closure and liquidation. In these circumstances, the ability to supply additional credit without the obligation to do so can be an important source of creditor leverage against a debtor.¹³³

In sum, the controls over management behavior usually available to creditors of a financially distressed corporation through the exercise of their contractual rights are inhibited by bankruptcy, but they do not disappear. If the debtor is unable to maintain adequate protection payments to a secured creditor or needs additional credit to sustain operations in bankruptcy, particular creditors may gain influence over management behavior.

4. Resistance to Management's Initiatives

Earlier we emphasized management's extensive powers of initiative with respect to both the business and reorganization plans. We also briefly discussed the processes for objection to those initiatives by creditors and shareholders.¹³⁴ With respect to the business plan, the normal process is to object to the bankruptcy court after receiving notice of a proposed transaction "other than

¹³³ Prepetition creditors often have greater incentives to provide the new financing than do strangers to the situation, and for this reason, they may be the only available lenders. By providing new financing, existing creditors may enable the business to survive and generate the funds necessary to pay both the old and the new loans. In addition, a creditor may be able to negotiate an improvement in its position with regard to the old loan. The most common form of improvement is "cross-collateralization"—the priority or security negotiated for the new loan applies to the old loan as well. *See, e.g., In re Roblin Indus., Inc.*, 52 B.R. 241 (Bankr. W.D.N.Y. 1985) (cross-collateralization permitted in a situation in which the prepetition claim may or may not have been fully secured). The cost of these priorities are borne not by the debtor, but by other creditors whose relative priorities have been reduced.

If one assumes that management's objective is to continue operations and that management is to some degree beyond the control of other parties to the reorganization case, it can then be demonstrated that it is in the interests of major prepetition creditors and management to form a coalition. The purpose of the coalition is to extend and accept the credit necessary to continue operations. Creditors benefit from enhanced priority for their old debt. The cost of the enhancement is normally passed along to now junior creditors in the form of increased risk. Management benefits from the possibility of a reduced interest rate on the new loan and the ability to continue the company in business. The model presented here is an extension of one first presented by Bulow & Shoven, *supra* note 53, at 437, and adapted in LoPucki, *supra* note 53, at 336-38, regarding coalitions between the major lender and shareholders. Because management is assumed to be able to act without the approval of shareholders, in the present context the coalition is formed with management rather than with shareholders.

¹³⁴ *See supra* notes 83-86 and accompanying text.

in the ordinary course of business."¹³⁵ When such an objection is made, the bankruptcy court will hold an adversary hearing and the parties will be able to use normal discovery processes in preparation for that hearing.¹³⁶

Curiously, the Code does not explicitly provide a standard for the court to apply in ruling on these objections. Probably most courts consider whether the proposed transaction is in the "best interests of the estate."¹³⁷ In making that judgment, they are likely to extend considerable deference to the expertise of management, for reasons similar to those that underlie the deference accorded management under the business judgment rule.¹³⁸ Significantly, there is no statutory requirement that the court consider the kinds of conflicts of interest that can exist between creditors and shareholders in the formulation of a business plan.

As was discussed earlier,¹³⁹ in preparing a reorganization plan management usually seeks and obtains the endorsement of the committees representing impaired classes. This perceived need for committee endorsement provides creditors, and to a somewhat lesser degree, shareholders, with leverage against management that the committees can apply to the plan of reorganization, the business plan, or other issues.

If management can sell all or substantially all of the assets of the company pursuant to § 363 of the Bankruptcy Code, it arguably circumvents the creditor and shareholder protections in the reorganization plan approval process.¹⁴⁰ On this basis, some courts have rejected management's attempts to sell major assets without the formalities of the reorganization plan approval process.¹⁴¹ But compliance with the plan confirmation process

¹³⁵ 11 U.S.C. § 363(b) (1988).

¹³⁶ See FED. R. BANKR. P. 9014 ("[R]elief shall be requested by motion, and reasonable notice and opportunity for hearing shall be afforded the party against whom relief is sought.")

¹³⁷ See, e.g., *Committee of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1068 (2d Cir. 1983).

¹³⁸ See Nimmer & Feinberg, *supra* note 94, at 12-14. See generally DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE 2* (3d ed. 1989) (explaining that courts will not usually second guess the merits of the decisions of the directors).

¹³⁹ See *supra* notes 51-52 and accompanying text.

¹⁴⁰ For an enumeration of these protections, see *supra* text accompanying notes 42-50.

¹⁴¹ See, e.g., *Committee of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1071 (2d Cir. 1983) (holding debtor applying for permission to conduct sale outside of ordinary course of business lacked business justification for

may take several months. If the proposed buyer is unwilling to wait for reorganization plan approval, the predominant view seems to be that the court should approve the sale if management has an "articulated business justification" for going ahead immediately rather than waiting for plan confirmation.¹⁴²

In addition to directly opposing management's plans through objections and voting, disgruntled creditors or shareholders can indirectly pressure management by bringing, or threatening to bring, vexatious litigation. We have discussed elsewhere the methods by which they sometimes proceed.¹⁴³ If they do not have official committee status they can seek it. Once they have that status they can retain counsel, and perhaps other professionals, whose fees will be paid by the debtor. The committee can conduct embarrassing discovery, expose the efforts of management or other parties to the reorganization to serve their self-interest, draw out negotiations over the plan, and inject uncertainty into the confirmation process. The primary limit on this power is the bankruptcy judge, who has discretion over the funding of this activity.¹⁴⁴

5. Fiduciary Obligations of Management

Directors and officers owe fiduciary duties to the corporations they serve. Among these duties are the duty of loyalty, which prohibits the director or officer from engaging in self-dealing to the detriment of the corporation itself or some constituent group to whom a fiduciary duty is owed, and the duty of care, which requires the use of reasonable care in making decisions on behalf of the corporation.¹⁴⁵

The law governing fiduciary duties of managers does not speak directly to the question of where management's loyalties should lie

selling without complying with plan formalities); *PBGC v. Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*), 700 F.2d 935, 939 (5th Cir. 1983) (stating district court was without power to approve sale not in the ordinary course of business because such a proposal would be short-circuiting requirements for confirmation of the reorganization plan).

¹⁴² See *In re Lionel Corp.*, 722 F.2d at 1070. For excellent discussions of this issue, see Nimmer & Feinberg, *supra* note 94, at 15-20; Skeel, *supra* note 7, at 494-505.

¹⁴³ See LoPucki & Whitford, *Preemptive Cram Down*, *supra* note 16, at 628.

¹⁴⁴ See *In re Heck's, Inc.*, 112 B.R. 775, 808 (Bankr. S.D. W. Va. 1990) (denying attorney fees to attorney for equity security holders committee).

¹⁴⁵ See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 138-56 (4th ed. 1990). Shareholders can sue directors and officers who violate their fiduciary duties. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (involving a solvent corporation).

when the interests of creditors and shareholders are in conflict.¹⁴⁶ But one might interpret it as so doing, by entertaining a questionable inference. The inference is that if a particular constituency is permitted to sue for breach of a fiduciary duty of loyalty or care, management has a duty to advance the interests of that constituency when they are in conflict with the interests of other constituencies.

No clear authority exists for or against the drawing of this questionable inference. The inference is suggested by the fact that when a particular constituency is permitted to sue for breach of a fiduciary duty, it is often said that the fiduciary duty is "owed" to that group. Nonetheless, the more usual understanding is that officers and directors have a duty to act for the benefit of the corporation, and that determining which groups are permitted to sue for its breach does not change what the officers and directors are expected to do.¹⁴⁷

Even if one accepts the inference, however, there is the additional difficulty that the cases are unclear as to whom management "owes" fiduciary duties. Most authorities agree that once insolvency intervenes, creditors can sue for breach of fiduciary duties by directors and officers.¹⁴⁸ There is considerable wisdom in this point of view. Once insolvency intervenes, it is creditors who

¹⁴⁶ In the following discussion we have benefitted greatly from Stephen H. Case, *Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases*, in ALI-ABA, CRITIQUE, *supra* note 90, at 373, 373-413.

¹⁴⁷ See *Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (In re STN Enters., Inc.)*, 779 F.2d 901, 904 (2d Cir. 1985) ("[T]he 'majority rule' permits recovery by creditors of an insolvent corporation for mismanagement as if the corporation itself were plaintiff . . .") (emphasis added).

¹⁴⁸ See *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 354-56 (1985); *STN Enters.*, 779 F.2d at 904; *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); *Berres v. Bruning (In re Bruning)*, 143 B.R. 253, 255-56 (D. Colo. 1992) (holding that a trust that arises in favor of creditors during insolvency is not a constructive trust, but a "technical" trust that puts officers and directors in a "fiduciary capacity" within the meaning of 11 U.S.C. § 524(a)(4) (1988)); *Chittenden Trust Co. v. Serbert Lumber, Co. (In re Vermont Toy Works, Inc.)*, 82 B.R. 258, 302 (Bankr. D. Vt. 1987); *Fox v. MGM Grand Hotels, Inc.*, 187 Cal. Rptr. 141, 143 (Cal. 1982); *Association of Haystack Property Owners v. Sprague*, 494 A.2d 122, 125 (Vt. 1985). In a few instances creditors have sought to establish that fiduciary duties are owed to them even when the corporation is solvent, but creditors have generally lost those suits. See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F.Supp. 1504, 1524-25 (S.D.N.Y. 1989) (stating that a creditor does not acquire an equitable interest in the corporation and is not owed a fiduciary duty); *Thomas R. Hurst & Larry J. McGuinness, The Corporation, The Bondholder and Fiduciary Duties*, 10 J.L. & COM. 187, 206 (1991) (stating that "prior cases provide little support for creation of fiduciary duty to bondholders").

will bear the bulk of the company's losses, so they should be able to initiate legal action when losses result from inappropriate management behavior. The case for a fiduciary duty to creditors is especially strong in bankruptcy, where creditors' contractual rights are suspended by the automatic stay. There is a growing number of statements, however, that post-insolvency fiduciary duties run *only* to creditors.¹⁴⁹ If that were an accepted statement of current law, it would be possible to argue that when a conflict of interest arises between creditors and shareholders, management of an insolvent corporation has a legal obligation to serve the creditors' interests.

We do not believe, however, that these statements should be viewed as establishing current law. First, contrary statements appear in both the cases and the law reviews.¹⁵⁰ Second, the view that managers of insolvent companies owe fiduciary duties only to creditors fails to recognize the very real interest that shareholders can have in the management of those companies. For many insolvent companies a substantial possibility exists for a return to solvency prior to the confirmation of a plan.¹⁵¹ Even if the company never returned to solvency, shareholders might be able to

¹⁴⁹ Perhaps the best known expression of this attitude was not directed at the issue of fiduciary duty as such. In the Second Circuit decision in *In re Johns-Manville Corp.*, concerning whether shareholders could demand a shareholder meeting and elect new directors during a chapter 11 proceeding, see *supra* notes 93-99 and accompanying text, the court stated in a footnote that if the company were insolvent "denial of the right to call a meeting would likely be proper, because the shareholders would no longer be real parties in interest." 801 F.2d 60, 65 n.6 (2d Cir. 1986); see also *FDIC v. Sea Pines Co.*, 692 F.2d 973, 977 (4th Cir. 1982) ("[W]hen a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors . . .") (quoting *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945)); *In re Baldwin-United Corp.*, 43 B.R. 443, 459 n.22 (S.D. Ohio 1984) (asserting that the "rule prevailing in most jurisdictions . . . is that when the corporation becomes insolvent . . . the directors of a Chapter 11 debtor are not fiduciaries of the corporation; rather, they are fiduciaries of the estate, which the debtor-in-possession holds as trustee for the creditors . . . [T]he nature of the directors' duty has changed from helmsman to guardian.") (citations omitted). There have also been several statements to such effect in recent legal scholarship. See *supra* note 7.

¹⁵⁰ See *Weintraub*, 471 U.S. at 355 ("[T]he fiduciary duty of the trustee runs to shareholders as well as to creditors."); *In re Central Ice Cream Co.*, 836 F.2d 1068, 1072 (7th Cir. 1987) (stating that duty of trustees is "to maximize the value of the estate, not of a particular group of claimants"); Frost, *supra* note 10, at 118-20 (arguing that "bankruptcy fiduciary duty points management in the direction of acting in the interest of both creditors and shareholders"); Nimmer & Feinberg, *supra* note 94, at 29-37 (stating that directors owe fiduciary duty to both creditors and shareholders in bankruptcy).

¹⁵¹ See *supra* notes 53-56 & 61 and accompanying text.

win a share of the distribution under the plan. If the value of those possibilities is reduced by the wrongful acts of management, shareholders should have a remedy.¹⁵²

We conclude that the better view is that management "owes" fiduciary duties to both the creditors and the shareholders of an insolvent company, until their claims or interests are extinguished as part of the reorganization case.¹⁵³ It follows that the law of fiduciary duty does not provide a reliable way for either creditors or shareholders to check management when it acts in an otherwise appropriate manner on matters with regard to which the interests of creditors and shareholders conflict.

Moreover, even if the law of fiduciary duty provided shareholders or creditors with arguments as to whose interests management should serve, in the reorganization context it would largely be of only theoretical value. Suits by either creditors or shareholders against management for breach of fiduciary duty for actions taken by them during a reorganization case are rare.¹⁵⁴ At least part of the explanation must lie in the fact that if creditors or shareholders are dissatisfied with the conduct of management, they have the opportunity to challenge that conduct directly in the reorganization

¹⁵² To provide a concrete example, suppose a company whose net worth is a negative \$10 million (and hence is insolvent). If management either negligently passes up (in violation of the duty of care) or converts to its own use (in violation of the duty of loyalty) a corporate opportunity that would increase net worth by \$100 million, shareholders are hurt to the extent of \$90 million (and creditors to the extent of only \$10 million).

¹⁵³ We have argued elsewhere that in some circumstances, it is appropriate to extinguish claims or interests before confirmation of a plan. See LoPucki and Whitford, *Preemptive Cram Down*, *supra* note 16, at 625-28.

¹⁵⁴ For proof they exist, see Frankel v. Frankel (*In re Frankel*), 77 B.R. 401 (Bankr. W.D.N.Y. 1987) (creditor sued chief operating officer after reorganization to hold officer's debt for breach of fiduciary duty of loyalty in failing to preserve collateral during reorganization as nondischargeable in officer's later bankruptcy case). Suits by creditors or shareholders initiated after the filing of a chapter 11 petition for breach of fiduciary obligation by management's conduct before the filing of the petition are relatively common. See, e.g., *In re STN Enterprises*, 779 F.2d 901, 904 (2d Cir. 1985) (unsecured creditors' committee sues owner/manager during reorganization for breach of fiduciary duties in period before filing); *In re Vermont Toy Works, Inc.*, 82 B.R. 258, 264-65 (Bankr. D. Vt. 1987) (denying secured creditor's complaint for declaratory judgment requesting determination that collateral it repossessed from debtor prepetition was not property of estate); *Fox v. MGM Grand Hotels, Inc.*, 187 Cal. Rptr. 141, 143 (Cal. 1982) (debenture holder brought class action on behalf of unsecured debenture holders against corporate issuers for intentionally acting to prejudice the interests of the unsecured creditors); *Association of Haystack Property Owners v. Sprague*, 494 A.2d 122, 124 (Vt. 1985) (purchasers' class action against directors of corporate vendor for breach of fiduciary duty).

case by moving for appointment of a trustee or objecting to a proposed transaction. If they do not challenge it, or are unsuccessful in their challenge, it is unlikely they could later prevail in an action against management for breach of fiduciary duty.¹⁵⁵

6. Employment Contract Incentives

The degree to which management will side with creditors or shareholders in formulating business and reorganization plans is likely to be influenced by management's perception of its own self-interest. For the solvent corporation, scholars have already developed theories of what behavior is in management's self-interest and how different corporate constituencies can structure management's incentives to their own benefit.¹⁵⁶ Management is seen as self-evidently interested in their own salaries and perquisites, in preservation of the company and therefore their jobs, and in their reputation as effective managers.¹⁵⁷ Management compensation schemes can be devised to link management's interests to those of shareholders.¹⁵⁸ Examples would be bonuses that increase when stock prices increase and options to purchase stock in the future at an already-fixed price.

These techniques for linking management self-interest to shareholder welfare lose their effectiveness when the company files for reorganization. Pre-existing management compensation programs are not binding on the debtor-in-possession; they are executory contracts that can be rejected.¹⁵⁹ Moreover, because the fortunes of the companies have been in decline, management probably is not faring well under existing incentive compensation schemes anyway. To provide substantial incentives for management

¹⁵⁵ The legal conception of fiduciary duty may nevertheless influence management behavior if management chooses to act consistently with its fiduciary obligations. Additionally, in ruling on challenges to management's actions based on other provisions of the bankruptcy code, a bankruptcy court may be influenced by its conception of management's fiduciary duties.

¹⁵⁶ See Jensen & Meckling, *supra* note 53, which is a classic work in this tradition.

¹⁵⁷ These latter interests in particular are thought to incline management to adopt more risk averse strategies than are desired by many shareholders. Management's interests would be severely compromised by insolvency, whereas shareholders can hold diversified portfolios and thus do not have so much at stake if the company becomes insolvent. See Coffee, *supra* note 58, at 16-24.

¹⁵⁸ See Demsetz, *supra* note 92, at 387 ("[A] linking of the interests of management to those of shareholders . . . is . . . supplied by correlating managerial wages and corporation performance.").

¹⁵⁹ See 11 U.S.C. § 365 (1988).

to serve the interests of shareholders, the compensation programs must be reformed. Because stock prices are low, the old shareholders may have to suffer substantial dilution to provide any real incentive for management to defend their interests. In itself, this may not be a problem. Considering the potential power of management to affect the amounts of distributions under the plan of reorganization, the shareholders of stock in a \$100 million company who currently expect to receive \$1 million of the distribution under a plan might be delighted to give 10% or even 25% of their shares to win the loyalty of management. But once the reorganization case has been filed, creditors, employees, and others are likely to take an interest in management compensation and the incentives it creates. They are likely to think that management's compensation should be tied to the success of the company, or perhaps even themselves,¹⁶⁰ not the success of shareholders. In the battle to determine the compensation scheme for management and thereby fix management's incentives, these other parties are likely to have the upper hand. Management's compensation during the reorganization case is subject to review by the bankruptcy court¹⁶¹ and any agreements for compensation to be paid after the case must be fully disclosed.¹⁶² The court is likely to believe that the managers of an insolvent company should serve the interests of the company, not the interests of holders of its underwater shares.

¹⁶⁰ See Gilson & Vetsuypens, *supra* note 76, at 30 (finding that CEO compensation in distressed firms sometimes was explicitly tied to creditor payoffs).

¹⁶¹ Though there is no section of the Bankruptcy Code that clearly and unambiguously authorizes court review of management compensation, a considerable majority of bankruptcy courts interpret §§ 327 and 330 as providing that authority. Those sections authorize the court to review the compensation of "professional persons." 11 U.S.C. §§ 327, 330 (1988); see *In re Phoenix Steel Corp.*, 110 B.R. 141, 142 (Bankr. D. Del. 1989); *In re Athos Steel & Aluminum, Inc.*, 69 B.R. 515, 521 (Bankr. E.D. Pa. 1987); *In re Zerodec Mega Corp.*, 39 B.R. 932, 935 (Bankr. E.D. Pa. 1984).

Some courts have held that corporate officers are not "professional persons" within the meaning of these sections but have nonetheless sustained the bankruptcy court's authority to review executive compensation under its general authority to enter any order "necessary or appropriate to carry out the provisions [of the Code] . . . or to prevent an abuse of process." 11 U.S.C. § 105(a) (1988); see *In re New York City Shoes, Inc.*, 89 B.R. 479, 483 (Bankr. E.D. Pa. 1988); *In re Lyon & Reboli, Inc.*, 24 B.R. 152, 153-54 (Bankr. E.D.N.Y. 1982).

¹⁶² See 11 U.S.C. § 1129(a)(5)(B) (1988). Sometimes the terms of management's post-confirmation compensation are made part of the plan of reorganization and approved as part of the plan approval process.

7. Employment Market Incentives

In the context of solvent corporations, some scholars argue that various market incentives, additional to those created by the employment contract, induce management to protect shareholder interests.¹⁶³ Here we address primarily whether the market for the services of managers can provide similar incentives within the context of a chapter 11 proceeding.¹⁶⁴

The market incentives argument posits that managers want to preserve their ability to obtain jobs with other firms at top salaries. That ability not only provides them an alternative should they lose their current job, it also gives them a basis to negotiate for higher salaries in their current jobs. Managers cannot "shirk" or enrich themselves at the expense of the company because this conduct would become known in the marketplace and adversely affect the managers' marketability.¹⁶⁵

¹⁶³ See, e.g., Easterbrook & Fischel, *supra* note 9, at 397 ("Shareholder's interests are protected not by voting but by the market for stock (and the managers' need to raise new capital), the market for goods, and the market for managers' services.").

¹⁶⁴ Like the market for the services of managers, the market for goods will likely lose much of its capacity to discipline management in the context of the insolvent, reorganizing company. We suppose that a reorganizing company could be so vulnerable that only the best efforts of management could save it and any attempt by management to serve other interests would quickly cause it to fail. In that case it could be argued that the market for goods, acting in tandem with the employment market for managers, provides incentives for management conduct. But we doubt that the financial condition of many large companies is so tenuously balanced. Furthermore, the analysis ignores the possibility that a manager's own interests may be served perfectly well even if the company does not survive. For example, management might engineer the closing of the business desired by creditors in return for releases or severance pay.

The market for capital, either in the form of loans or purchases of equity, does sometimes provide incentives for particular management conduct. But if management seeks to appeal to the market for loans, their incentives may be to serve creditor interests rather than shareholder interests. See *supra* notes 130-33 and accompanying text. Management seldom have reason to be concerned about the market for the company's debt or equity securities. Although management theoretically could finance the reorganization through a public offering, that was not done in any of the cases we studied and has only rarely been done in cases outside our study. Managers who want to retain their jobs will not necessarily be happy to discover new investors willing to purchase a controlling interest in the company during reorganization; such investors will almost certainly replace management with persons of the investors' own choosing. See *infra* Table V accompanying note 203.

¹⁶⁵ This literature suggests that the labor market for management services provides an incentive for managers to acquire a *reputation* for serving shareholder interests (or not to shirk), perhaps because it is too difficult to control management behavior solely by providing sufficient economic incentives to act in shareholder interests. See Demsetz, *supra* note 92, at 387 ("The many years of investment in . . .

In the context of insolvent, reorganizing companies, the analysis becomes more complex. First, some of the managers of these companies have no intention of seeking another managerial position. They may be so tainted by the financial demise of their company that they are unemployable. Their primary concern may be to avoid criminal or civil liability or to obtain as much severance pay as possible.

Other managers are sufficiently tainted that they cannot be viable candidates for other managerial positions unless they can first restore their companies to financial health. These managers can be expected to cling tenaciously to their jobs and vigorously contest efforts to liquidate the company.¹⁶⁶ Their bias in favor of reorganization makes them natural allies of shareholders, particularly in companies that are insolvent. But that does not necessarily mean they will solely serve the interests of shareholders. If they wish to continue in their current employment, they will want to serve whoever is in control. As we demonstrate throughout this Article, creditors often exert considerable control over a reorganizing company.

If the corporation is insolvent, then a substantial majority of the voting shares of the emerging company will most likely be distributed to creditors upon confirmation of the plan.¹⁶⁷ One might expect that incumbent managements would seek to identify these incipient shareholders and serve their interests. But management's calculus of its self-interest in this regard is complicated by the fact that most of these incipient shareholders will sell their shares shortly after they receive them. For example, banks, usually the largest creditors in the cases we studied, are prevented by banking regulations from holding reorganization securities for more than about two years after their receipt.¹⁶⁸ Through our study, we

reputation [by managerial personnel] are not lightly put at risk in the pursuit of the advantages offered by shirking."); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 296 (1980) ("[A] manager's talents and his tastes for consumption on the job . . . must be imputed by managerial labor markets at least in part from information about the manager's current and past performance.").

¹⁶⁶ For an interesting case study of such behavior by corporate managers, see BARBARA MARSH, *A CORPORATE TRAGEDY: THE AGONY OF INTERNATIONAL HARVESTER COMPANY* 238-94 (1985). The latter portion of this book recounts the efforts of International Harvester Company to restructure its debt and avoid both liquidation and bankruptcy. The chief executive officer who led this effort, Archie McCardell, resigned when it failed. The company never filed for bankruptcy, but in the end it liquidated most of its assets and paid the proceeds to creditors.

¹⁶⁷ See LoPucki & Whitford, *Patterns*, *supra* note 16, at 18.

¹⁶⁸ The Bank Holding Company Act of 1956 generally prohibits bank holding

discovered that they frequently dispose of them much more quickly than that. It is possible that a manager who expected the shares to be sold to investors not yet identifiable would wish to cultivate a reputation for serving shareholder interests, because equity investors will want a manager with such a reputation.¹⁶⁹

An alternative to serving the interests of those who will control the emerging corporation is to serve the interests of those who hire managers in the marketplace. The preferences of the latter are not all the same. Some of the managers of companies in our study appeared to be cultivating reputations for saving financially distressed companies.¹⁷⁰ Their reputations might appeal to

companies from owning shares of non-banking companies, but it contains an exception for "shares acquired by a bank holding company . . . in satisfaction of a debt previously contracted . . . but such shares shall be disposed of within a period of two years from the date on which they were acquired." 12 U.S.C. § 1843(c)(2) (1988) (emphasis added).

Banks, as opposed to bank holding companies, are regulated by the Banking Act of 1933 (Glass-Steagall), ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.), which contains no such specific provision. Before the adoption of Glass-Steagall, case law had established that national banks, although generally prohibited from owning shares in non-banking companies, could acquire such shares by way of payment of debt, but only with a view that the shares would be promptly resold. See *First Nat'l Bank v. National Exch. Bank*, 92 U.S. 122, 128 (1875) ("In the honest exercise of the power to compromise a doubtful debt owing to a bank, . . . stocks may be accepted in payment and satisfaction, with a view to their subsequent sale or conversion into money so as to make good or reduce an anticipated loss."); *McBoyle v. Union Nat'l Bank*, 122 P. 458, 459 (Cal. 1912) ("[W]here a national bank had bought stock pledged to it, its duty [was] to dispose of such stock as soon as a sale . . . could be made."). Given the regulatory purposes of the Glass-Steagall Act, it is generally assumed that the statute did not expand the powers of national banks to own securities; quite the contrary, the statute was intended to restrict those powers. See generally *Investment Co. Inst. v. Camp*, 401 U.S. 617, 632 (1971) (holding that under Glass-Steagall commercial banks could not enter the investment banking business based on the fact that Congress wanted to prevent commercial banks from making "loans to customers [which] would facilitate the purchase of stocks and securities"). Hence, it is generally assumed that the pre-statutory requirement that shares acquired as payment of debt be resold quickly still applies.

¹⁶⁹ In some of the cases we studied, investors assembled controlling blocks of shares after confirmation by purchasing from creditors who received the shares under the plan. This was true, for example, in the case of *Anglo Energy*. See *Business Briefs*, WALL ST. J., Nov. 19, 1986, at 28 (announcing an "orderly transfer of control" of Anglo's board of directors to Equity Strategies, a mutual fund). Because investors who acquire entire companies nearly always install new management, see *infra* Table V accompanying note 203, managers who anticipate those events might regard their situation as hopeless.

¹⁷⁰ These managers are sometimes called turnaround experts. For example, Sanford Sigiloff, who had previously managed the turnaround of Daylin, Inc. (earlier case not in our study), managed the turnaround of Wickes Companies (in our study) and then went on to manage the turnaround of L.J. Hooker Corp. (later case not in

shareholders or junior creditors who seek management with a bias in favor of reorganization. To enhance such a reputation, a turnaround expert might tend to favor the interests of shareholders and junior creditors against their seniors, but within limits. In the reorganization of insolvent companies, it is unlikely that shareholders or junior creditors ever have the unfettered ability to make hiring decisions.¹⁷¹ Other managers appeared to be cultivating reputations for liquidating financially distressed companies.¹⁷² These managers presumably would be interested in making themselves attractive to creditors, who are likely to be in

our study).

¹⁷¹ Creditors in this situation are fearful about appearing to direct corporate affairs because of concern that they will later be found to have assumed fiduciary responsibilities, as the party in control of the corporation, to other corporate constituencies. See, e.g., *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661, 690 (Tex. Ct. App. 1984) (holding creditors liable for interfering with a debtor's business, based on the assertion that a debtor is "entitled to have its affairs managed by competent directors and officers who would maintain a high degree of undivided loyalty to the company"). Compare Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 146-47 (1989) (arguing that imposing a fiduciary duty on lenders is inappropriate since fiduciary duties are intended to govern agency relationships, not arms-length transactions such as financing) with Dan S. Schechter, *The Principal Principle: Controlling Creditors Should Be Held Liable For Their Debtors' Obligations*, 19 U.C. DAVIS L. REV. 875, 882-85 (1986) (arguing that controlling creditors should be held partly liable for a debtor's obligations upon its insolvency on the grounds that controlling creditors receive extra benefits over other creditors without incurring any additional liability). Nonetheless, it is beyond dispute that creditors frequently are consulted about management turnover decisions, and boards of directors are frequently careful to hire somebody that potential future lenders will find acceptable. We report empirical data about creditor involvement in management turnover decisions *supra* notes 112-22 and accompanying text.

¹⁷² Victor Palmieri, who had managed the liquidation of the Penn Central Railroad (not in our study), then managed the liquidations of Baldwin-United and EPIC (both in our study).

William Scharffenberger cultivated a more ambiguous reputation. He oversaw the partial liquidation of Penn-Dixie Steel and the complete liquidation of Saxon Industries (both in our study). In the latter case, the creditors' committee initially proposed a business plan of complete liquidation; Scharffenberger did not resist and cooperated fully with the efforts of the creditors' committee to find the most advantageous buyer. Scharffenberger resisted efforts by the equity committee to block the sale favored by the creditors' committee. After the Saxon reorganization plan was confirmed, Scharffenberger was hired as CEO of Wheeling-Pittsburgh Steel Co., which was attempting to reorganize. This company is not in our study because a reorganization plan was not confirmed until Dec. 12, 1990, well after the deadline required for inclusion in our study. Scharffenberger also resigned as CEO of Wheeling-Pittsburgh after confirmation. See Jonathan P. Hicks, *Chairman Will Leave Wheeling-Pittsburgh*, N.Y. TIMES, Mar. 20, 1991, at D4; *Wheeling Steel Plans an Earnings Charge*, N.Y. TIMES, Dec. 29, 1990, at 31.

control when a company seeks new management to oversee a liquidation.

In sum, managers' concerns for their own future employability gives them an interest in establishing a reputation during the reorganization, but it is difficult to predict the direction in which those considerations are likely to bias those managers. Given the number and volatility of those considerations, it may make sense for managers to avoid choosing sides, an effort we observed in many of the cases studied.

C. *Judicial Power*

Nearly every type of power exercised by management, shareholders, or creditors is exercised subject to the discretion of the bankruptcy court. To give but a few examples, if there is objection, the court must approve most transactions that will be part of management's business plan, such as sales of assets, the borrowing of money, or rejections of executory contracts.¹⁷³ The debtor's right of exclusivity expires 120 days into the case, unless the court extends it for cause.¹⁷⁴ Perhaps most importantly, the court can influence bargaining through monitoring,¹⁷⁵ mediating, setting deadlines by scheduling matters for adjudication, or regulating the amount and time of payment of the fees and expenses of the lawyer negotiators.¹⁷⁶ With this broad array of weaponry, it would seem that a skilled, aggressive bankruptcy judge who wished to do so could wield virtually complete power over the governance of a reorganizing company. In a few of the cases we studied, the judges did so; but in most they did not. Based on interviews and our own independent analysis, we concluded that, aside from extending

¹⁷³ See *supra* notes 134-38 and accompanying text.

¹⁷⁴ See 11 U.S.C. § 1121(b) (1988). Of course, the judge's ultimate control over governance of the corporation lies in the judge's discretion to order the appointment of a trustee.

¹⁷⁵ In many of the cases in our study, this tactic was pursued at hearings on the debtors' motions for extensions of exclusivity, where the parties were often asked to report on the progress of negotiations. Courts following this approach typically granted extensions at intervals of one to three months. In a few cases, monitoring was accomplished through the appointment of an examiner.

¹⁷⁶ During most of the period of our study, the courts split as to whether bankruptcy judges could raise various matters on their own motion or whether they had to wait for a motion by a party in interest. In 1986, Congress amended 11 U.S.C. § 105 to expand the *sua sponte* powers of the bankruptcy court, and those powers are now quite broad. See *Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986*, Pub. L. No. 99-554, § 203, 100 Stat. 3088, 3097.

exclusivity for the duration of the case, the judges played an insignificant role in eighteen of the forty-three cases (42%), and that the judges played a major role in only eleven of the forty-three cases (26%).¹⁷⁷

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TABLE III
BANKRUPTCY JUDGES' ROLE IN PROCEEDINGS

Name of Case	Cumulative Role of Judge	Exclusivity Extended for Duration of Case
Air Florida	Major	Extended
AM International	Insignificant	Extended
Amarex	Insignificant	Lifted
Anglo Energy	Major	Lifted
Baldwin-United	Significant	Extended
Braniff	Significant	Extended
Charter	Significant	Extended
Combustion Equipment	Significant	Extended
Continental Airlines	Major	Extended
Cook-United	Insignificant	Extended
Crystal Oil	Insignificant	Extended
Dreco	Insignificant	Extended
Energetics	Insignificant	Extended
EPIC	Insignificant	Extended
Evans Products	Major	Lifted
FSC	Significant	Lifted
HRT	Significant	Extended
Itel	Insignificant	Extended
Johns-Manville Corp.	Major	Extended
KDT	Insignificant	Extended
Lionel	Major	Extended
Marion	Major	Lifted
McLouth	Insignificant	Extended
MGF	Significant	Lifted
NuCorp	Major	Lifted
Oxoco	Insignificant	Extended
Penn-Dixie	Insignificant	Extended
Phoenix Steel	Insignificant	Extended
Pizza Time Theatre	Significant	Lifted
Revere	Significant	Extended
Salant	Insignificant	Extended
Sambo's Restaurants	Significant	Lifted
Saxon	Major	Extended

The two cases in which judges played the greatest role will demonstrate the exercise of judicial power at the extreme. In the Johns-Manville reorganization, the judge held "oversight hearings" to monitor negotiations, appointed a future health claimants' representative who frequently consulted with the judge and became "the catalyst for, if not the architect of" the reorganization plan,¹⁷⁸ pressured lawyers to accept the proposals of the representative, and twice enjoined shareholders from holding their annual meeting. When equity balked at the plan, the judge disbanded their committee. As a result, the common shareholders, who had voted against the plan, were not represented by counsel at the cramdown hearing. The judge confirmed the plan, and the confirmation order was upheld on appeal.¹⁷⁹

In the Evans Products reorganization, the judge permitted exclusivity to expire only 120 days into the case. Even though the company bordered on solvency and cram down would ultimately turn on the testimony of investment bankers about the value of the securities being issued, the judge denied the motion of the official Non-Insider Equity Committee to retain an investment banker or an accountant. The controlling shareholder, a highly unpopular corporate raider, blocked acceptance of a plan that would have distributed \$18 million to equity. The Non-Insider Equity Committee sued to compel acceptance, but the judge refused to

Seatrains Lines	Insignificant	Extended
Smith International	Insignificant	Extended
Storage Technology	Significant	Extended
Tacoma Boatbuilding	Significant	Extended
Technical Equities	Significant	Extended
Towle	Insignificant	Extended
Towner	Major	Extended
White Motor	Major	Extended
Wickes	Insignificant	Extended
Wilson Foods	Significant	Extended

Column two is based on information we collected about the cases, and interviewees' responses to two questions: (1) What role did the judge play in the case? and (2) Did the judge condition extensions of exclusivity on progress in negotiations? We then categorized the judges' role as "insignificant," "significant," or "major." The judgment as to significance of the role is our own. Column three indicates whether exclusivity was extended until it was too late to file a competing plan, regardless of whether a competing plan was filed.

¹⁷⁸ *In re Johns-Manville Corp.*, 68 B.R. 618, 626 (Bankr. S.D.N.Y. 1986).

¹⁷⁹ *See Kane v. Johns-Manville Corp.*, 843 F.2d 636, 650 (2d Cir. 1988).

intervene. The bank creditors then filed a different plan providing nothing for equity. In the face of conventional wisdom that litigation over valuation was so complex and unwieldy as to be impractical, the judge scheduled a confirmation hearing with only a single day for the presentation of evidence and argument, and he informed counsel that no additional time would be allocated. At the hearing, the same judge crammed down the plan—the only time equity holders with representation were “zeroed out” in the cases in our study.¹⁸⁰

It seems remarkable that the kind of power exercised in these two cases goes unused in so many other cases.¹⁸¹ Judicial restraint seems to be a norm in large reorganization cases. The implicit understanding is that the appropriate judicial role involves deciding issues brought before the court by parties in interest. That each bankruptcy judge is assigned, on the average, more than 3000 new cases each year may also have something to do with such restraint.¹⁸²

D. Summary

In this Part we have examined the foundations of management power and canvassed a variety of ways in which creditors and shareholders can influence or control the exercise of that power. To summarize, the fundamental source of management's power is its ability to remain in office after the filing of the reorganization case and to initiate the business and reorganization plans. Shareholders may be able to vote the managers out of office and creditors may be able to oust them through the appointment of a trustee, but neither of these events is likely. The automatic stay relieves the debtor of the necessity to repay already outstanding debt.

¹⁸⁰ See *In re Evans Prods. Co.*, 65 B.R. 31, 34 (Bankr. S.D. Fla. 1986).

¹⁸¹ For another account of a case in which the judge played a very active role in overseeing the case, see RICHARD B. SOBOL, *BENDING THE LAW: THE STORY OF THE DALKON SHIELD BANKRUPTCY* (1991). The judge in that case was a district judge, not a bankruptcy judge. According to the report by Sobol, in a case in which top management owned a major portion of the shares, the judge actively steered the outcome of the proceedings towards the interests of shareholders and management. The plan also released management from liability for breaches of fiduciary duty prior to confirmation. See *infra* note 230.

¹⁸² See, e.g., *BANKRUPTCY YEARBOOK AND ALMANAC* 6, 353-446 (Christopher M. McHugh ed., 1992) (reporting 943,987 bankruptcy filings during 1991, handled by approximately 300 bankruptcy judges).

Individually or through their committees, creditors and shareholders can resist management's implementation of the business plan in court, but this direct approach is unlikely to be successful. Their leverage against management is much greater with regard to the plan of reorganization, where the consent of creditors is considered to be a virtual necessity and the consent of organized equity holders only somewhat less so. The perceived need for creditor consent to the reorganization plan may give creditors sufficient leverage to affect or control the business plan. If the debtor must seek additional credit from existing creditors, it may also fall under their hegemony.

Neither creditors nor shareholders are likely to take formal legal action against managers for perceived breaches of the managers' fiduciary duty of loyalty. Prepetition employment incentive contracts are unlikely to motivate management to serve the interests of shareholders once the reorganization case has been filed. But contracts entered into postpetition may motivate management to serve particular interests, most likely those of creditors. Finally, the market for management services may provide important incentives for management behavior during reorganization, but the effect is uncertain as to both its magnitude and direction.

Together, the mechanisms discussed in this Part comprise the system of corporate governance during the reorganization of large, publicly held companies. The most prominent attribute of this system is its complexity. Depending on the circumstances and the inclinations of the principal actors, any one of these sources of power may become predominant in a particular case. But it is more likely that several influences over management power will operate in a particular case, and each will pull management in a somewhat different direction. Because these influences work in such a conflicted environment, it is difficult to predict how management will view their incentives in a particular case, let alone in a population of cases.

III. THE APPLICATIONS OF MANAGEMENT POWER

In this Part we present empirical evidence about how much power management had in the cases studied and for whose benefit they exercised it. There is an ambiguity in the concept of management power. In economic analyses, the choices people make are presumed to be self-serving. If, for example, a manager eschews salary and bonuses, instead allowing the money to be distributed to

creditors and shareholders, the economist will say it is because the manager derives more utility from allowing the money to be distributed. From this perspective, managers are bound in service to their own self-interest. If power is defined as having discretion to determine the course of events, the only power managers have is to choose between alternatives of precisely equal value to them, or to make mistakes.¹⁸³ Because of differences in the information available to them, their abilities, and what they value, not all managers will make the same choices, but they will all have the same objective—to maximize their own utility.

In this Part we will consider management to have greater power or autonomy when it appears that they have exercised their legal authority in ways that serve their self-interest but do not simultaneously serve the interests of other parties. In keeping with the perspective of economic analysis, we will assume that if management acted in a way that benefited creditors or shareholders it must be because those groups could impose sanctions on management. Because of the threatened sanctions, management came to understand that acting in the interests of another group was also in management's self-interest. We will describe such a management as having had less power or autonomy. We will first address the extent of management's power, and then discuss which groups have benefitted from management's actions. In the latter discussion, we will in effect be describing which groups were able to compel management to act in the group's interest.

A. Methodology

Inquiry into these matters is difficult because there are no simple, objective measures that can be used. How does one measure the extent of management's autonomy or power, and then compare it with the autonomy or power of management in a different case? There are some objective benchmarks, such as whether management stayed in office and preserved the exclusive power to propose a plan. But even they are not unambiguous. The lifting of exclusivity will not necessarily diminish the power of management much; other parties may lack the information needed

¹⁸³ See Jeffrey L. Harrison, *Egoism, Altruism, and Market Illusions: The Limits of Law and Economics*, 33 UCLA L. REV. 1309, 1311 (1986) (noting that the "egoism" theory of law and economics "holds that all decisions, unless mistaken, are by definition self-interested. All choices . . . are designed to maximize personal utility").

to prepare a viable reorganization plan. In addition, a management with all the trappings of power may in fact be compelled to do the bidding of creditors; the managers may fear that a trustee will be appointed or that needed interim financing will not be forthcoming.

We encountered similar problems in determining whose interests management served. It was usually possible to discover whether management favored a liquidation or continuation of the company, and whether they proposed or advocated a distribution to equity in a reorganization plan. Yet these facts alone do not reveal whose interests were being advanced. Though liquidation is commonly in the interests of creditors and reorganization serves the interests of shareholders, they may not in particular cases. Even if we know that management negotiated for a substantial distribution to equity in violation of the absolute priority rule, we cannot foreclose the possibility that management had the power to insist on an even greater violation, but chose not to insist on it.

Our conclusions, then, are necessarily somewhat subjective. We have drawn extensively on our interviews with the attorneys.¹⁸⁴ We have not simply accepted at face value what these attorneys told us. In fact, different attorneys in the same case did not always have the same opinion about such matters as the extent of management power and in whose interest it was exercised. Rather, we have interpreted what we were told, testing it against other information about the cases derived from other sources, such as official documents and newspaper stories. This methodology runs the risk that other researchers might well have reached different conclusions from the same sources of information, but there seems no other way to address empirically the questions we have posed.

The utility of many empirical studies depends upon the degree to which the sample of cases studied reflects the universe of cases about which the study seeks to draw its conclusions. We chose to study all chapter 11 reorganizations filed under the Bankruptcy Code by or against publicly held corporations, if the bankruptcy

¹⁸⁴ In each case we attempted to interview the principal lawyers for the debtor, the creditors' committee and the equity committee (if appointed). In all but a few instances, we were able to obtain the requested interviews. In a few cases, we interviewed another lawyer who also played a key role in the case (e.g., an attorney for a group of bank creditors). We conducted a total of 125 interviews. Some of the interviews were in person; the majority were by telephone. The interviews ranged from about 20 minutes to about an hour and a half in length, and many topics were covered. The power and loyalties of management were central issues addressed in each interview.

petition reported \$100 million or more in assets and the confirmation of the reorganization plan occurred before March 15, 1988.¹⁸⁵ Because we studied all cases within the indicated time-frame and size limit, we did not need to calculate the probability that a relationship not present in the universe of cases was present in our sample purely by chance. The cases we studied may differ from those currently before the bankruptcy courts because of changes in the patterns of management behavior, the law, or other factors.¹⁸⁶ Where we have reason to believe such changes have occurred, we so note.

B. *How Much Power Does Management Have?*

1. Management Turnover as an Index of Power

We have already reported several empirical indications that management's power was extensive in the cases studied. Trustees were rarely appointed.¹⁸⁷ Shareholders tried to discipline management by electing new directors in only four instances; in two of the four the court enjoined the attempt.¹⁸⁸ Management retained the exclusive authority to propose a plan of reorganization for the duration of all but nine of the forty-three cases we studied.¹⁸⁹

One finding conflicts dramatically with this image of management power during reorganization. The turnover rate for the CEOs of these distressed companies was much higher than the turnover rate for CEOs of most large, publicly held companies. In the period starting eighteen months before filing and ending six months after confirmation, there was at least one change in CEO in thirty-nine of forty-three cases (91% of the total number of cases).

¹⁸⁵ The Bankruptcy Code first became effective on October 1, 1979. See Act of Nov. 6, 1978, Pub. L. No. 95-598, § 402(a), 92 Stat. 2549, 2682. Our closing date for our sample was dictated by the need to study the cases before we conducted our attorney interviews. The majority of those interviews were conducted over the summer of 1988.

¹⁸⁶ Even though the law governing reorganization practice has remained stable since 1979, we noticed that the practice itself has been evolving. We hypothesize that this evolution reflects a process of experimentation and learning on the part of lawyers, judges, and other participants in the cases. Reorganization practice is dynamic.

¹⁸⁷ See *supra* notes 112-16 and accompanying text.

¹⁸⁸ See *supra* notes 96-108 and accompanying text.

¹⁸⁹ See Table III, *supra* note 177.

TABLE IV
CEO TURNOVER
Eighteen months before filing to six months
after confirmation¹⁹⁰

Case	Exiting CEO	Time of turnover (months from filing)	During ¹⁹¹ bankruptcy?	Time of turnover (months from confirmation)
Air Florida	Lloyd-Jones	-2		
AM International	Ash	-15		
	Black	-2		
	Freeman		yes	-6
Amarex	Mason	+17	yes	
Anglo Energy	Johnson	-3		
	Rhodes		yes	0
Baldwin-United	Thompson	-5		
	Palmieri Mgmt		yes	+1
Braniff	Lawrence	-16		
	Casey	-4		
	Putnam		yes	-3
	States			+3
Charter	Mason	+1	yes	
Combustion	Benningson	+1	yes	
Equipment	Madden	+12	yes	
	Kalven		yes	-6

¹⁹⁰ Time of turnover is shown in relation to filing or confirmation, whichever is closer in time to the CEO's departure. A negative number indicates that the turnover occurred before the event. A turnover is considered to have occurred a stated number of months before or after confirmation if it occurred closer to that number of months before or after confirmation than to any other number of months. To illustrate: a zero indicates that the turnover occurred within 15 days before or after the event. If the bankruptcy case was filed on January 1, a "+1" indicates that the turnover occurred during the period from January 16 to February 14. Because a different system of counting was used in preparing Figures I and II, the number of months shown on this Table for a particular resignation may be one month less than the number shown in those figures.

¹⁹¹ A turnover was considered to have occurred "during bankruptcy" if it occurred after the filing of the petition and before confirmation of the plan, or if it was contemplated by the parties at the time the plan was confirmed. We considered a resignation to be contemplated by the plan of reorganization if it was agreed to by the CEO before or contemporaneous with confirmation of the plan. In some cases, the agreements were reported in newspapers or we learned of them through interviews. In others, the "agreement" was no more than an understanding among all concerned that the resignation was inevitable because the CEO's position was no longer viable.

Continental Airlines	No turnover during period			
Cook-United	Jeffers	-18		
	Hanson	+11	yes	
Crystal Oil	Roberts	-10		
	Averett		yes	+5
Dreco	Pheasey	+1	yes	
	Goldress		yes	-13
Energetics	Smith	-6		
	Reagan	-1		
EPIC	Billman	0	yes	
	MDIF Management		yes	0
Evans Products	Orloff	-13		
	Posner		yes	0
FSC	Garland/Garmasi	-1		
	Portnoy/Powers	0		
HRT	Solomon		yes	+3
Itel	Redfield/Friedman	-18		
	Tan	-10		
Johns-Manville Corp.	Maloon		yes	-7
	Kunzel		yes	+1
Johns-Manville Corp.	McKinney		yes	-4
KDT	Kittay (died)	-2		
	Green		yes	0
Lionel	Saypol	+5	yes	
	Wasserman	+14	yes	
Marion	Stickelber	+10	yes	
	Blohm			0
McLouth	Gann	+4	yes	
	Deaner	+11	yes	
MGF	Major	-17		
	Marcum		yes	0
Nucorp	Burns	-2		
	Watts	+6	yes	
Oxoco	Orr	-17		
	Henderson			+6
Penn-Dixie	Castle	-18		
	Scharffenberger		yes	+1
Phoenix Steel	No turnover during period			
Pizza Time Theatre	Bushnell	-2		
	Pike	0	yes	
Revere	Montgomery	+4	yes	
	Munro	+6	yes	
Revere	Collins		yes	-10
Salant	Forcheski	+1	yes	
Sambo's Restaurants	Shaughnessy	+2	yes	
	Luckey	+21	yes	

Saxon	Lurie	0	yes	
	Sharffenberger		yes	+1
Seatrain Lines	No turnover during period			
Smith International	Neely		yes	0
	Rollins			+6
Storage Technology	Awieda	+1	yes	
	Wands	+3	yes	
Tacoma Boatbuilding	Low	-5		
Technical Equities	Stern	-1		
	Gates	0	yes	
	Wiley	+1	yes	
	Wilcox		yes	+1
Towle	Florence	-4		
Towner	Towner	-6		
White Motor	Knudsen	-14		
	Moss	+7	yes	
Wickes	McNeely	-1		
Wilson Foods	No turnover during period			
TOTALS	76 exiting CEOs		45 exits during bankruptcy	

In thirty-one of these cases (72% of the total number of cases) there was at least one change in CEO during the pendency of the chapter 11 case, or contemplated by the plan of reorganization. The changes were concentrated around the two critical dates in a reorganization case, filing and confirmation. The first concentration was during the three-month period beginning two months before the filing of the reorganization case. The second concentration occurred in the month after confirmation. Other studies have found a "normal" CEO turnover rate of approximately 10% annually for large, publicly held firms.¹⁹² If retirements are

¹⁹² We draw our information about the "normal" CEO turnover rate from the many studies now being published attempting to link corporate performance to CEO turnover. Two recent publications provide an annual CEO turnover rate comparable to the data we have collected. Fazel and Louie used a sample drawn from *Forbes'* annual report on executive compensation for 1984-85, and determined that 72 of the 706 CEO's were replaced in a one-year period. See John L. Fazel & Kenneth K.T. Louie, *CEO Retention, Firm Performance and Corporate Governance*, 11 *MANAGERIAL & DECISION ECON.* 167, 169 (1990). In another study, Puffer and Weintrop used a sample of 480 large, publicly held U.S. corporations traded on the New York and American stock exchanges and found a CEO turnover rate of 11% for 1983. See Sheila H. Puffer & Joseph B. Weintrop, *Corporate Performance and CEO Turnover: The Role of Performance Expectations*, 36 *ADMIN. SCI. Q.* 1, 6-7 (1991).

excluded, the annual turnover rate for "normal" CEOs would be considerably lower.¹⁹³ For the CEOs of the companies we studied, the comparable annualized turnover rate during the first concentration period (around filing) was 167% per year.¹⁹⁴ For the second concentration period (the month after confirmation) the annualized turnover rate was 307%.¹⁹⁵

Surprising as these statistics are, they are consistent with two other recent studies of CEO turnover during bankruptcy reorganizations. Gilson reported that only 29% of "senior managers"—defined as the CEO, the chairman of the board, and the president—remained with the firm over a four year period beginning two years before filing.¹⁹⁶ Betker found that only 9% (18 of 202) of the top managers who held office two years before default still held office one year after confirmation.¹⁹⁷

Some of the departures in the cases studied were voluntary; the CEOs could have remained in office if they had chosen to do so. For example, several of the CEOs who departed had established

¹⁹³ Puffer and Weintrop excluded firms where the departing CEO was over age 63, on the theory that retirement probably produced the turnover. They then found an annual turnover rate of 5.3%. See Puffer & Weintrop, *supra* note 192, at 7. Weisbach studied turnovers among firms on the *Forbes* 500 list for 1970-80 and excluded turnovers where the CEO was within one year of 65, again on the theory that the turnover was caused by retirement. He found an annual turnover rate between 4 and 5% in his sample. See Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 438, 454 (1988).

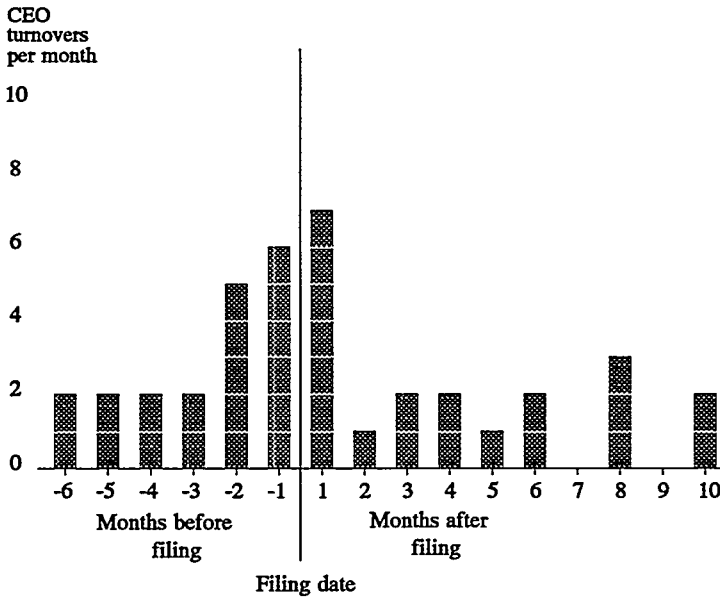
¹⁹⁴ There were 18 CEO turnovers during this period. Seven of them occurred in the month after filing. See *infra* Figure I accompanying note 198. The 18 turnovers were divided among the 43 cases, an average of 0.4186 turnovers per case. We annualized that turnover rate by dividing it by 1/4, the portion of a year included in the first concentration period. That is, on the average, 1.67 turnovers occurred during each case year of the concentration period.

¹⁹⁵ In the month after confirmation there were 11 turnovers. See *infra* Figure II accompanying note 201. In most of these cases, some or all of the parties consented to confirmation only after there was agreement on management turnover. The 11 turnovers were divided among the 43 cases, an average of 0.2558 turnovers per case. We annualized that turnover rate by dividing it by 1/12, the portion of a year included in the second concentration period. That is, on the average, 3.07 turnovers occurred during each case year of the concentration period.

¹⁹⁶ See Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 247 tbl. 3 (1989).

¹⁹⁷ See Betker, *supra* note 40, at 8.

FIGURE I¹⁹⁸
CEO TURNOVER AROUND FILING DATE



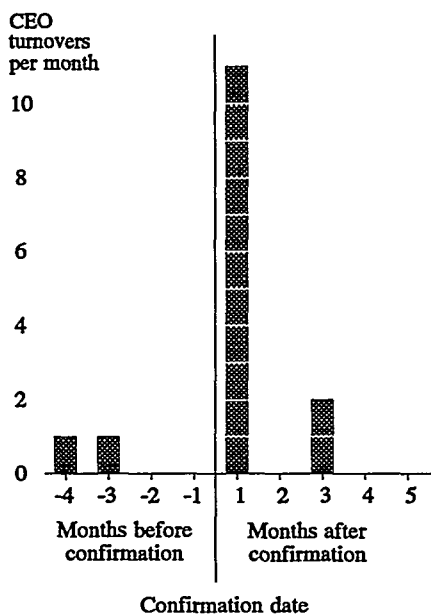
reputations as turnaround managers or liquidators. Apparently in accord with their intention at the time they took office, they managed their companies until confirmation and then moved on to other similar positions.¹⁹⁹ Another CEO who had served a long term in office left when he reached retirement age.²⁰⁰ Though the company was in reorganization, there was no indication that his

¹⁹⁸ Figures I and II are based on data which differs slightly from that presented in Table IV *supra* accompanying note 190. The data in Table IV is based on calendar months, while the data in this figure is based on a precise count of days from the turnover to filing. Since the time from filing to confirmation varied for each of the companies, this figure and the next do not represent the bulk of the time between those two time periods. But the actual length of the proceedings is irrelevant, since our data show that the turnover of the CEOs is concentrated around these two events and the bankruptcy proceedings were not so short as to make the two figures overlap.

¹⁹⁹ See *supra* note 172.

²⁰⁰ William F. Collins of Revere Copper & Brass. Mr. Collins continued to serve as Chairman of the Board of Directors after his resignation as CEO.

FIGURE II²⁰¹
CEO TURNOVER AROUND CONFIRMATION DATE



resignation was forced. For nearly all of the other CEO changes in our study, however, the resignation appeared to be involuntary.

In an effort to elaborate on these findings, we examined each case to determine the fate of the CEO who was in office at the time of the business failure that led to bankruptcy. Of the forty-two companies that had such "tainted" CEOs, only the ones who headed Seatrain Lines and Phoenix Steel remained continuously in their positions through confirmation of a plan of reorganization.²⁰² Thus the rate of attrition for these "tainted" CEOs was 95%.

²⁰¹ See *supra* note 198.

²⁰² See *infra* Table V accompanying note 203.

TABLE V
 TURNOVER OF TAINTED CEOs²⁰³

Company name & Name of tainted CEO ²⁰⁴	Date tainted CEO left	Months from filing	Creditor participation in departure of tainted CEO? ²⁰⁵	Debtor's CEO hired by purchaser to run the business?
Air Florida Acker	Sept. 1981	-33	no	no sale of business
AM International Ash	Feb. 1981	-15	no	no sale of business
Amarex Mason	May 1984	+17	yes	no
Anglo Energy Johnson	Aug. 1983	-3	no	no sale of business
Baldwin-United Thompson	Apr. 1983	-6	no	no

²⁰³ This Table shows the names of the "tainted" CEOs in the cases studied and the times of their departures. The fourth column shows whether creditors participated in the departures of the tainted CEOs. The last column shows whether purchasers of the debtors' businesses hired the CEOs who were serving immediately prior to the sales to continue to run those businesses.

²⁰⁴ We defined a CEO as tainted if the CEO was in office during the last profitable year before filing and remained in office after it was apparent that the company was in serious financial difficulty. While this theoretically rendered it impossible to identify a manager in many hypothetical circumstances, in the large majority of cases it presented no problem. The tainted manager served from long before the company's financial difficulties arose until their manifestation was obvious. In a few cases, we could not determine which of two CEOs who held office successively should be considered tainted, but the problem was moot because both resigned before confirmation.

In three of the 40 cases, the tainted CEO did not leave office until after confirmation, but it was contemplated at the time of confirmation that he would leave shortly thereafter. The CEOs were Posner (Evans Products), Solomon (HRT), and Neely (Smith International).

²⁰⁵ We consider creditors to have "participated" in a turnover decision if we have evidence that powerful creditor interests requested or suggested a change of CEO, and the other information we have about the case is consistent with an assumption that the change of CEO resulted in increased creditor influence over the reorganization process. As we discussed earlier, there are many ways in which creditors can exert pressure on the board of directors of a reorganizing company. See *supra* notes 112-72 and accompanying text. In determining whether there was creditor participation in CEO turnover, we interpreted our information conservatively—that is, we did not attribute a turnover to creditor pressure unless we had convincing information to that effect. We are confident, therefore, that creditor participation in CEO turnover in the cases studied was even more extensive than we report. In some instances the *Wall Street Journal* attributed the change to creditor pressure. None of these attributions conflicted with our own interview data; we accepted all of them.

Braniff Lawrence	Dec. 1980	-16	yes	no
Charter Mason	May 1984	+1	yes	no sale of business
Combustion Equipment Benningson	Nov. 1980	+1	yes	no
Continental Airlines [Lorenzo's predecessor]	Oct. 1982	-11	no	no sale of business
Cook-United Jeffers	Feb. 1983	-18	no	no sale of business
Crystal Oil Roberts	Aug. 1985	-10	no	no sale of business
Dreco Pheasy	July 1982	+1	yes	no sale of business
Energetics Smith ²⁰⁶	May 1984	-5	yes	no sale of business
EPIC Billman	Sept. 1985	0	no	no sale of business
Evans Products Orloff	1984	about -12	yes	no sale of business
FSC Garland/Garmasi ²⁰⁷	Aug. 1981	-1	no	no sale of business
HRT Solomon	Feb. 1984	+15	no	no
Itel Redfield	July 1979	-18	yes	no sale of business
Johns-Manville Corp. McKinney	Aug. 1986	+48	yes	no sale of business
KDT Kittay ²⁰⁸	June 1982	-2	no tainted CEO departure	no
Lionel Saypol	June 1982	+4	yes	no sale of business
Marion Stickelber	Jan. 1984	+1	no	no sale of business
McLouth Gann	May 1982	+4	yes	yes
MGF Major	July 1983	-17	yes	no sale of business
NuCorp Burns	May 1982	-2	no	no sale of business
Oxoco Carr	Apr. 1985	-17	yes	no sale of business

²⁰⁶ Smith was later reinstated as CEO, but only after nearly all of the company's assets were surrendered to its principal lender.

²⁰⁷ The two served simultaneously as CEO.

²⁰⁸ Kittay died in office.

Penn-Dixie Castle	May 1977	-23	no	no sale of business
Phoenix Steel Hug		Survived	no tainted CEO departure	no sale of business
Pizza Time Theatre Bushnell	Feb. 1984	-2	yes	no
Revere Collins	Aug. 1984	+22	no	no sale of business
Salant Forcheski	Mar. 1985	+1	no	no sale of business
Sambo's Restaurants Battistone	July 1979	-28	no	no sale of business
Saxon Lurie	Apr. 1982	0	no	no
Seatrains Lines Pack		Survived	no tainted CEO departure	no sale of business
Smith International Neely	Nov. 1987	+20	yes	no sale of business
Storage Technology Aweida	Dec. 1984	+1	yes	no sale of business
Tacoma Boatbuilding Lowe	Apr. 1985	-7	no	no sale of business
Technical Equities Stern	Jan. 1986	-05	yes	no sale of business
Towle Florence	Nov. 1985	-5	no	no sale of business
Towner Towner	Apr. 1984	-5	no	no sale of business
White Motor Knudsen	July 1979	-14	no	no sale of business
Wickes McNeely	Mar. 1982	-1	yes	no sale of business
Wilson Foods No tainted CEO ²⁰⁹			no tainted CEO departure	no sale of business

Tainted CEOs were not the only ones to suffer abnormally high rates of attrition. We also discovered abnormally high rates among the replacement CEOs who succeeded them in office. We defined a "replacement" CEO as a CEO who was not tainted, court-appointed as a trustee, or interim. We considered a CEO interim if the manager served only during the search for his successor.²¹⁰ Some replacement managers were hired with the expectation they

²⁰⁹ This company had no profitable year after it was spun off from LTV Corporation. Therefore, by our definition, it had no tainted CEO.

²¹⁰ The masculine pronoun is used because all CEOs in the cases studied were men.

would serve only during reorganization; we included them in the category of replacement managers. We investigated the turnover rates for replacement CEOs for the period from filing of the reorganization case to thirty days after confirmation of the plan. We determined the number of replacement CEOs who left office during the period and divided it by the total number of years that replacement CEOs served in office during the period.²¹¹ The rate of turnover was 31% per year, several times the rate of turnover for the CEOs of large, publicly held companies.²¹²

TABLE VI
TURNOVER OF REPLACEMENT CEOs²¹³

Company name & Name(s) of CEO(s)	Type of manager	Replacement manager years for this case	Replacement manager turnover during case
Air Florida Tinkle	replacement	2.2	no
AM International Freeman Banta	replacement replacement	2.5	yes no
Amarex Mason Hillman Mgt.	tainted replacement	1.5	no no
Anglo Energy Rhodes	replacement	2.8	yes
Baldwin-United Palmieri	replacement	2.6	yes
Braniff Putnam States	replacement replacement	1.4	yes no
Charter Mason Moody	tainted replacement	2.7	no no

²¹¹ See *infra* note 213.

²¹² See *supra* notes 192-93 and accompanying text.

²¹³ This Table shows the data from which we calculated the rate of turnover for non-tainted ("replacement") CEOs during the period from the filing of the bankruptcy case to 30 days after confirmation of the plan. That rate is the ratio of turnovers of replacement CEOs during the subject period (24), divided by the total number of years served by all replacement CEOs during the subject period (76.25). Thus, we eliminated from the numerator the turnovers of tainted CEOs and court-appointed trustees during the subject period and we eliminated from the denominator those portions of the subject period during which a tainted CEO or a trustee served as CEO. We also eliminated from the denominator the period after sale of all of the company's assets and during which the company had no CEO. The turnover ratio thus calculated was 31% per year.

Combustion Equipment		3.2	
Benningson	tainted		no
Kalven	replacement		yes
Thomas	replacement		no
Continental Airlines		2.9	
Lorenzo	replacement		no
Cook-United		2.1	
Hanson	replacement		yes
Lurie	replacement		no
Crystal Oil		.3	
Averett	replacement		no
Dreco		3.0	
Pheasey	tainted		no
Goldress	replacement		yes
Grant	replacement		no
Energetics		0.7	
Smith	replacement ²¹⁴		no
EPIC		0.7	
Billman	tainted		no
MDIF	replacement		yes
Palmieri	replacement		yes
Evans Products		1.4	
Posner	replacement		yes
FSC		3.7	
Uhl	replacement		no
HRT		0	
Solomon	tainted		no
IteI		2.3	
Maloon	replacement		yes
Kunzel	replacement		yes
Johns-Manville Corp.		0.5	
McKinney	tainted		no
Hulce	replacement		no
KDT		1.7	
Green	replacement		yes
Lionel		3.3	
Saypol	tainted		no
Wasserman	replacement		yes
Vastola	replacement		no
Marion		2.2	
Stickelber	tainted		no
Blohm	replacement		yes

²¹⁴ Smith was the CEO before the bankruptcy petition, but was replaced and later reinstated before the filing as well.

McLouth		2.8	
Gann	tainted		no
Deaner/Panney ²¹⁵	replacement		no
MGF		3.1	
Marcum	replacement		no
NuCorp		0.5	
Watts	replacement		yes
Galt	trustee ²¹⁶		no
Oxoco		0.4	
Henderson	replacement		no
Penn-Dixie		1.9	
Scharffenberger	replacement		yes
Phoenix Steel		0	
Hug	tainted		no
Pizza Time Theatre		1.2	
Montgomery	replacement		yes
Munro	replacement		yes
Leisner	replacement		no
Revere		1.0	
Collins	tainted		no
Williamson	replacement		no
Salant		2.2	
Forcheski	tainted		no
Williams	replacement		no
Sambo's Restaurants		2.0	
Shaughnessy	replacement		yes
Luckey	replacement		yes
McLaughlin	trustee ²¹⁷		no
Saxon		3.0	
Lurie	tainted		no
Scharffenberger	replacement		yes
Seatrain Lines		0	
Pack	tainted		no
Smith International		0	
Neely	tainted		no

²¹⁵ During the case, while Deaner was managing McLouth Steel, the company sold substantially all of its assets, including the name McLouth Steel, to Tang Industries. Deaner continued as CEO of the Tang subsidiary that contained the assets. The debtor company changed its name to MLX and reorganized around the company's net operating losses (NOLs). Because neither Deaner nor Panny lost their jobs during the remainder of the case, we did not have to determine which of them was CEO of the "real" McLouth Steel.

²¹⁶ Galt was appointed trustee January 11, 1983. We do not include his tenure in office in computing the total time that replacement managers served.

²¹⁷ McLaughlin was appointed trustee December 8, 1983. We do not include his tenure in office in computing the total time that replacement managers served.

Storage Technology		2.7	
Aweida	tainted		no
Pappa	replacement		no
Tacoma Boatbuilding		2.0	
Stansfield & Machinist	replacement		no
Technical Equities		1.5	
Wiley	replacement		yes
Wilcox	replacement		no
Towle		1.6	
Dunphy	replacement		no
Towner		1.3	
Zilkha	replacement		no
White Motor		3.3	
Moss	replacement		yes
Askins	replacement		no
Wickes		2.5	
Sigeloff	replacement		no
Wilson Foods		0	
Griggy	unclassified ²¹⁸		no
TOTAL		76.25	24

It is not entirely clear what caused the rates of turnover for these companies to be so high. Several factors were at work. The reorganizing companies we studied were frequently bought and sold; the buyer nearly always installed its own CEO even if there was no particular reason to be dissatisfied with the performance of the incumbent.²¹⁹ Some companies were liquidated piecemeal; reorganization eliminated the job of CEO along with the company. Replacement managers that came from within the companies may have been so closely linked to the ousted managers that they fell heir to the ousted manager's opposition.²²⁰ If one assumes retaining their jobs is a high priority for managers, these findings

²¹⁸ Griggy was neither a tainted manager nor a replacement manager. For that reason, we do not include Wilson Foods in the statistic on the rate of turnover for replacement managers.

²¹⁹ See *supra* note 59.

²²⁰ Examples include Pizza Time Theatre, in which three successive replacement managers from within the company lasted a total of about eight months, and Manville, in which the hand picked successor of the outgoing CEO drew so much criticism that the appointment was scrapped shortly after it was announced. Our sources conflict as to whether the replacement CEO in Manville ever actually assumed office. The managers of companies not in financial distress may be less likely to have serious opposition.

suggest that managers have relatively little power during bankruptcy reorganization.

This conclusion is strengthened by evidence that CEO turnover frequently resulted from creditor pressure.²²¹ Drawing on news reports and our interviews with attorneys participating in the cases, we found evidence that creditors “participated” in causing the departure of eighteen of the forty tainted CEOs who left office before or during the reorganization.²²²

The high attrition rate for tainted managers might be explained by a cultural norm that when a large, publicly held company suffers the kind of massive loss²²³ that leads to bankruptcy reorganization, someone must take the blame. By analogy to the notion of ministerial responsibility in parliamentary governments, perhaps the CEO must accept responsibility when something goes wrong on the CEO’s “watch.” But the fact that replacement managers also have a high rate of turnover indicates that more than a cultural norm is involved. Management autonomy is limited. Chapter 11 is not a safe haven for incumbent management, as it is sometimes described.²²⁴

²²¹ See Gilson, *supra* note 196, at 249 tbl. 4 (finding evidence of creditor pressure in 20 of 176 top management (CEO, president, or board chair) changes based on *Wall Street Journal* reports); Betker, *supra* note 40, at 10 (finding evidence of creditor pressure in 12 of 68 CEO changes based on the same sources).

²²² See *supra* Table V accompanying note 203. Considering only the tainted CEOs who left during the bankruptcy case, the level of creditor participation is even higher. Nine of 14 such departures (64%) involved creditor participation. See *supra* Table V accompanying note 203. The rate of creditor participation in departures may have been higher during reorganization because (1) creditors sought to remove CEOs only after the boards failed to do so or (2) creditors had less fear of lender liability for participating in the debtor’s personnel decisions once the reorganization proceeding had been commenced. It is also possible that creditor participation was as high before as during reorganization, but our methodology was more likely to discover participation during reorganization.

²²³ The magnitude of these losses is reflected in the losses of the companies’ investors. Creditors received what they were owed at filing in only five of the 43 cases we studied. See LoPucki & Whitford, *Bargaining Over Equity’s Share*, *supra* note 16, at 166 tbl. IV(A). If one assumes that creditors are not made whole unless they receive both what they are owed at filing plus interest at market rates between filing and confirmation (a period that averages over 2.5 years), then creditors received full payment in only one of the 43 cases we studied. See *id.* at 176 tbl. IV(B). Except when the company was solvent, shareholders received relatively minimal distributions. See *id.* at 142 tbl. III.

²²⁴ See *supra* note 10.

2. Coverups and Grabs as Indicators of Management Power

One of the *Douglas Report's* principal criticisms of the pre-1939 procedure for reorganization was that managers were able to remain in control of the company and manipulate the reorganization case for their own benefit. The report particularly emphasized management's ability to use that control to foreclose investigations into their own prior wrongdoing.²²⁵ In this section we attempt to assess the degree to which this criticism remains valid under post-1979 reorganization procedure.

Managers in the cases studied were certainly not uniformly successful in foreclosing investigation into their own wrongdoing. In four of the cases, CEOs ousted from control were later indicted for defrauding the company.²²⁶ The SEC brought administrative charges against several others.²²⁷ Replacement managements sometimes pursued claims against previously dismissed managers for the benefit of the corporation and the claimants in the reorganization proceeding.²²⁸

²²⁵ See Dodd, *supra* note 80, at 225-31.

²²⁶ In Saxon, Penn-Dixie, and Technical Equities, the "tainted" CEO was indicted and convicted of fraud. Each received a prison sentence. See *Technical Equities Founder Gets 5 Years for Fraud*, L.A. TIMES, Nov. 11, 1988, pt. IV, at 2 (Technical Equities); *Business Briefs*, WALL ST. J., Jan. 20, 1986, at 7 (Saxon); *Former Penn-Dixie Chief Officer is Fined, Given 15-Month Term*, WALL ST. J., Oct. 23, 1979, at 34 (Penn-Dixie). In EPIC, the "tainted" CEO was indicted but became a fugitive from justice. See Paul W. Valentine, *Fugitive Head of Md. S&L Faces U.S. Charges*, WASH. POST, Jan. 31, 1990, at B7.

²²⁷ See, e.g., *Ex-Baldwin Chief Settles*, N.Y. TIMES, Apr. 18, 1987, at B30 (Morley Thompson, former CEO of Baldwin-United, charged by SEC with accounting irregularities, and proxy solicitation and fraud violations; case settled by consent order); Bill Ritter, *Judge Rules Ex-Nucorp Boss Committed Fraud*, L.A. TIMES, Dec. 20, 1985, pt. IV, at 1 (Richard Burns, former CEO of Nucorp, found to have defrauded investors and creditors in a case brought by the SEC; Burns enjoined from violating SEC regulations in the future); Robert E. Dallos, *Big Accounting Firm Charged with Fraud*, L.A. TIMES, June 21, 1985, pt. IV, at 2 (former AM International executives charged with accounting irregularities by the SEC).

In a number of cases, shareholder and creditor groups brought fraud actions against the former managers. Since these actions were against the managers in their individual capacities, they were not automatically stayed by the corporation's bankruptcy. When successful, these actions in effect increased the recovery of the plaintiff classes. See, e.g., Bill Ritter, *Several Nucorp Suits Settled for \$41 Million*, L.A. TIMES, Mar. 12, 1986, pt. IV, at 2 (Richard Burns, former CEO of Nucorp, settled class action by shareholders for \$41 million). In interviews, we were told that a class action by creditor classes against former executives of Technical Equities was settled for an amount that allowed those creditors to recover 30 to 40% of their claims even before there was any distribution from the bankruptcy estate.

²²⁸ This occurred in the cases of Technical Equities, EPIC, and Baldwin-United.

But events in other cases suggest that reorganization procedure sometimes enables managers to escape liability for their wrongdoing. Through its strong presumption against appointment of trustees and its grant of considerable powers of initiative, reorganization procedure gives even badly tainted managers leverage to negotiate their exits.²²⁹ As part of the exit deal, management may receive a release of liability.²³⁰ The filing of the reorganization case may also have the effect of hindering or delaying actions by defrauded creditors and shareholders against current and former managers.²³¹ These continuing problems demonstrate that the

In each of these cases, damages actions against former officers were unresolved at the time of confirmation. Since it was anticipated that the proceeds of the action would be substantial, the reorganization plan made special provision for the distribution of the proceeds once the litigation was resolved. In *Baldwin-United*, for example, a trust was established and assigned the claim against former managers, with various creditors made beneficiaries of the trust. We estimate that the value of the trust constituted more than 15% of the total distribution to unsecured creditors and equityholders in that case.

²²⁹ For example, in *Manville*, the CEO McKinney was essentially forced out of office by creditors. At the time of his exit, he negotiated severance pay of more than \$1.1 million. Such an exchange is perhaps even easier to accomplish before a reorganization case is filed because court approval is not required. For example, the co-CEOs who founded *Intel Corporation* and led it to financial disaster resigned 18 months before the filing of the reorganization case, pursuant to an agreement under which they received slightly less than \$1 million in severance benefits. The court-appointed examiner later concluded that the co-CEOs had breached fiduciary duties to the company. The examiner recommended that the company rescind the agreement and sue to recover the benefits, but the report was never acted upon, and the co-CEOs kept the money. *International Harvester Company*, a case not in our study, provides another example. In that case, CEO Archie McCardell received some \$600,000 in severance pay in return for his resignation. See *MARSH, supra* note 166, at 273. The company never filed bankruptcy, but eventually liquidated most of its assets and paid the proceeds to creditors.

²³⁰ For example, in *Braniff Airways*, management proposed a plan of reorganization that provided for the release of both present and former managers from all liabilities that arose before the confirmation date, including possible liability for mismanagement. See *Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code at 95-100, In re Braniff Airways, Inc., No. 482-00369 (Bankr. N.D. Tex. July 15, 1983)*. Though the provision was controversial and of questionable legality, all classes of creditors and shareholders voted in favor of the plan. It was confirmed and the managers were released.

A similar provision was included in the plan of reorganization that was confirmed in *In re A.H. Robins Co.*, 880 F.2d 694, 701 (4th Cir.), cert. denied, 493 U.S. 959 (1989). In the *Texaco* bankruptcy, a provision of the plan exempted corporate officers of any liability to the corporation for breach of fiduciary duty. See *In re Texaco, Inc.*, 84 B.R. 893, 900 (Bankr. S.D.N.Y. 1988).

²³¹ For example, in *Pizza Time Theatre*, the tainted CEO resigned before filing, but left the company in the hands of allies. When defrauded bondholders sued the former CEO, the company was able to persuade the bankruptcy court to enjoin the

1979 reform has given at least some managers who led their companies into financial distress the ability to inhibit inquiry into their wrongdoing and to escape liability for it.

In the course of our study, we became suspicious that some CEOs were using leverage generated from the power vested in the debtor-in-possession by the Bankruptcy Code to negotiate increases in their personal compensation.²³² To investigate this possibility, we collected data on the levels of CEO compensation and the circumstances in which that compensation was negotiated. When we concluded that, because of the bargaining leverages provided to management by the Bankruptcy Code, compensation was higher than it otherwise would have been, we labeled it a management "grab." This effort involved a good deal of subjective judgment on our part because there are no readily available bench marks for determining what compensation would have been under ordinary circumstances. Compensation for the managers of large, publicly held companies varies considerably.²³³

In analyzing our data, we began with a presumption that compensation was not the product of a "grab." We nevertheless were able to identify five reasonably clear "grabs" in our study of forty-three cases.²³⁴ In addition to these five cases, there were

action for a period of time. See Debtor's Second Amended Disclosure Statement at 18, *In re Pizza Time Theatre, Inc.*, No. 584-00941-M (Bankr. N.D. Cal. Mar. 13, 1985).

A second example from our study is the Amarex case. Management were the representatives of a controlling shareholder block whose members were defendants in a class action for allegedly misleading investors in the company. On the basis of our interviews, we are fairly certain that management's primary goal in the reorganization was to limit the amount of useful information about the company obtainable by the representatives of the class action plaintiffs. In fact, the defendants ultimately settled the class actions on favorable terms. Management was also concerned about protecting the interests of limited partner investors in partnerships in which the company was the general partner. These limited partner investors included many persons with whom the controlling shareholder interests had continuing business relations, and their interests did receive favorable treatment in the bankruptcy reorganization.

²³² For example, in McLouth Steel, creditors forced the resignation of the CEO about six months after filing and brought in an outside management team to run the company. About two months after its arrival, the new management team demanded and received substantial bonuses. Because management had just forced give-backs from the unions, the bonus demands embarrassed virtually everyone concerned. But at that time it would have been very difficult for the company to find new management because its continued existence was in serious doubt. Creditors and the court acceded to the demand.

²³³ See John A. Byrne, *The Flap Over Executive Pay*, BUS. WK., May 6, 1991, at 90, 90-112 (reporting that compensation for CEOs among 365 large, publicly held companies ranged from \$210,000 annually to \$18,000,000 annually).

²³⁴ The cases are Cook-United, HRT, McLouth Steel, Seatrain Lines, and Tacoma

three other cases in which management successfully renegotiated their employment contracts during plan negotiations. While acquiescence in these demands by the other parties certainly could be seen as concessions to management's reorganization bargaining leverages, in each instance management could plausibly defend the award as justified by their extraordinary service in bringing the company successfully through the reorganization, and by the need to keep the management team in place in the years immediately after confirmation. As a result, we could not clearly classify these cases as "grabs."²³⁵

Boatbuilding. The information reported below about these cases comes principally from the disclosure statements accompanying the plans that were confirmed, subsequent SEC 10-K statements, and interviews we conducted with attorneys in the cases.

In Cook-United, an outside investor provided a small amount of cash and considerable consulting help in return for four of eleven seats on the Board of Directors. A member of the investor group was appointed CEO. The reorganization plan, confirmed a year later, allocated that CEO shares with a value, by our calculations, of over \$1,800,000, plus some additional options. This allocation was in addition to the shares allocated to the investor group as part of the original deal.

In HRT, the incumbent CEO went along with a plan under which a controlling interest was awarded to outside investors in return for a cash contribution that was used to fund distributions to creditors under the plan. Before agreeing to this plan, however, the CEO negotiated a four year employment contract, which the creditors' committee and the outside investors agreed to support. The contract was entered into even though it was understood by all concerned that the outside investors intended to bring in their own management. A few months after confirmation, the outside investor group bought out the CEO's contract for \$1,100,000, plus a one year \$200,000 consulting contract.

McLouth Steel is discussed *supra* note 232.

In Seatrain Lines, the company almost totally liquidated over the six year period it was in chapter 11. Management received five year employment contracts at confirmation, a deal that they insisted upon in return for their support of the reorganization plan.

In Tacoma Boatbuilding, a case which resembles Cook-United in some respects, outside investors acquired control of the company before reorganization and installed their own managers. After suffering additional financial reverses, the investor's shares were grossly underwater and the investor ceased to be a major player in the case. The managers continued in office and successfully proposed a plan of reorganization that provided themselves with one-third of the reorganization shares.

²³⁵ The three cases are AM International, Salant, and Wickes. The information reported below comes principally from the disclosure statements accompanying the plans that were confirmed, subsequent SEC 10-K statements, and interviews we conducted with attorneys involved in the cases.

In AM International, the CEO was given a three year employment contract shortly before confirmation. Under this contract, the CEO not only received a \$300,000 annual salary, but at confirmation he received shares worth about \$600,000 plus options to purchase four times as many additional shares at a potentially favorable price.

We consider these grabs evidence that in some reorganization cases management derives considerable power from their incumbency. That we could not identify more grabs may indicate that the various checks on management power work in most cases. We cannot conclude that solely self-serving management behavior was as pervasive as it appears from the *Douglas Report* to have been prior to 1939.²³⁶

C. *For Whose Benefit Did They Manage?*

As one might expect, when we asked lawyer-interviewees whose interests a particular manager served, their responses were not always consistent. Our task was complicated by the fact that often more than one CEO was in office during the period in which the business and reorganization plans were being formulated. In an effort to bring some order to the massive amount of information we collected, we invented four distinct models of management behavior during reorganization. We then examined the data for each of our cases to see which of our models most clearly and reasonably described the behavior of the CEO or CEOs exercising management authority when the business and reorganization plans were being formulated and approved.

The models that we invented are as follows:

1. *Aligned with creditor interests.* By "aligned," we mean that management generally took the side of creditors in the exercise of its discretion during the case. We also included cases in which management was aligned with one creditor group against

In Salant, the CEO received a five year employment contract at confirmation, plus shares worth about \$1 million. This executive was given credit by all parties for having reversed the company's fortunes, and his continued presence at the company was considered important to its future success.

In Wickes, senior management received as a bonus a package of cash, short term notes, and warrants to purchase stock that had an estimated value of \$18 million. About one-fourth of this package went to the CEO. The CEO also entered into a five year employment contract at confirmation at a salary approaching \$1 million annually. As in Salant, the management team in Wickes received credit from most parties for having done an excellent job in leading the company through reorganization and providing a greater distribution to creditors under the reorganization plan than had once been thought possible.

²³⁶ In fact, it may be that management has as much or more of this institutionally generated leverage in the absence of bankruptcy. At least if the debtor has filed bankruptcy, other parties have ready access to legal process to control management excesses.

another creditor group (e.g., with secured creditors against unsecured creditors).

2. *Aligned with shareholder interests.* Management advocated what they considered to be the interests of shareholders, or some class of shareholders—even if they did not cooperate with an equity committee that had been appointed.²³⁷

3. *Maximize the estate.* Management was not aligned with either creditors or shareholders. Instead, management sought to maximize the value that could be distributed under the reorganization plan and did not hesitate to liquidate assets if that seemed the best way to do so. These managements did not play an active role in negotiating about the strictly distributional issues that are covered in a reorganization plan.²³⁸

4. *Preserve the company.* Management was not aligned with either creditors or shareholders. Instead, management was committed to preserving some part of the traditional business as a going concern under the same corporate structure. This goal could serve the interests of various parties, including management itself if it preserved their jobs. The actual beneficiaries of the policy varied from case to case.

We classified a management as “aligned with” creditors or shareholders if they fit one of those two definitions. Only if they did not, did we consider whether to place them in one of the other two categories. Classification of a management as aligned with creditors or shareholders, therefore, does not imply that the management did not attempt to maximize the estate or preserve the company.

²³⁷ The Evans Products case provides an extreme example of a management that advocated the interests of shareholders but did not work cooperatively with the official equity committee. See *infra* note 242.

²³⁸ In these cases, management might take an active interest in the financial structure of the post-confirmation company, believing that the amount of debt outstanding relative to equity can affect the total value of the reorganizing company. See generally RICHARD A. BREALY & STEWART C. MEYERS, PRINCIPLES OF CORPORATE FINANCE 407-37 (3d ed. 1988) (outlining a theory of optimal capital structure based upon an analysis of taxes, risk asset type, and the need for financial slack). But once the basic financial structure was determined, management was indifferent as to who should receive the various securities.

A "preserve the company" orientation often served primarily the interests of shareholders. Even though our "aligned with shareholders" category does not require active cooperation with the equity class, but only identification with their welfare, we considered it appropriate to create a separate category for two reasons. First, there are circumstances in which reorganization is very much in the interests of creditors. For example, unless creditors stand to recover all or substantially all of their claims through liquidation, a capture of the going concern value of the company through reorganization will redound largely to their benefit.²³⁹ Second, managements adopting a "preserve the company" approach typically profess to be motivated by goals distinct from the interests of either creditors or shareholders. These goals may include preserving the "institution" as an end in itself, and protecting the welfare of employees, suppliers, customers, and the communities in which the company's businesses operate.

In a number of cases, management behavior seemed to have characteristics of several of our categories. In one case, management was closely aligned with creditors on most issues but with shareholders on others. Another management fought to preserve the company, but when that effort failed and creditors forced liquidation, that management's new objective seemed to be to obtain a grab. In still other cases, managers resigned during the relevant period and their successors seemed to follow different models. We did not classify the managements in these cases. Finally, we did not classify the behavior of the trustees in the two cases in which trustees were appointed.

Even after those exclusions, we were able to classify the managements of twenty-five of our forty-three cases. The results are shown in the following table.

²³⁹ As we reported in an earlier article, in cases in which large, publicly held companies are insolvent, distributions to equity classes tend to be small. See LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 142 tbl. III.

TABLE VII
MANAGEMENT ORIENTATIONS²⁴⁰

	Aligned with creditors	Maximize the estate	Preserve the company	Aligned with equity
Solvent	None	Penn-Dixie	Salant Smith International Storage Technology	AM International Charter Continental Airlines
Insolvent	Air Florida Cook-United FSC HRT McLouth MGF Oxoco Seatrain Lines Technical Equities	Baldwin-United Pizza Time Theatre Saxon	Anglo Energy Braniff Phoenix Steel Wickes	Dreco Evans Products
TOTAL	9	4	7	5

Several implications can be drawn from this table. First, management does not consistently favor or represent either creditor or shareholder interests. Although this finding is contrary to the assumptions and conclusions of numerous authorities,²⁴¹ it should not be surprising. The sources of, and checks on, management power are numerous and sensitive to variations in the underlying facts. In light of such complexity, it would be surprising indeed if managers aligned themselves with the same interests in every case, or even if their behavior was easily predictable.

Second, the alignment of management is clearly a function of solvency. The managements of solvent companies never aligned with creditors; the managements of insolvent companies aligned with creditors far more frequently than they aligned with shareholders. The same correlation with solvency would hold if we placed managements who sought to maximize the estate in the creditor column and managements who sought to preserve the company in the shareholder column.

Third, management aligned with shareholders in only five cases.²⁴² It is interesting to note that in all five cases large

²⁴⁰ Of the 18 cases we could not classify, four concerned solvent companies and the remaining 14 were insolvent.

²⁴¹ See *supra* notes 8-9 and accompanying text.

²⁴² In two of the five, the alignment was far from perfect. In Evans Products, the

shareholders held seats on the board of directors. We suspect that the existence of an active shareholder who holds a large block of shares is an important factor in equity's ability to command the allegiance of management. Among the thirty-two cases of insolvent debtors, management aligned with shareholders only twice, and in both of those cases a shareholder owning a controlling block of shares was personally involved in management.²⁴³

In addition to our classifications of management, several other findings from our study buttress the conclusion that creditors dominate many of the managements of insolvent, reorganizing companies. First, recall that creditors frequently participated in CEO turnover in circumstances consistent with the assumption that the turnover resulted in greater creditor influence over management conduct.²⁴⁴

Second, when chapter 11 was enacted, some commentators anticipated that reorganization plans for large, publicly held companies would deviate substantially from the absolute priority rule, because they assumed that management would have substantial power to determine the outcome and would act in the interests of shareholders.²⁴⁵ In an earlier article, we documented that while there were systematic deviations from the absolute priority rule among the cases of the clearly insolvent debtors studied, those deviations were usually small.²⁴⁶ If management had substantial

major shareholder and the equity committee were in open opposition to each other. The creditors' committee and the equity committee agreed on a plan that provided the equity class with a distribution valued at \$18 million. The CEO (Victor Posner), who was also the major shareholder, owning 42% of the shares, blocked approval of the plan. The creditors then withdrew their support of the plan and instead sought and obtained confirmation by cram down of a plan that provided equity with nothing. We classified this management as nonetheless aligned with shareholders because the CEO's actions, though ultimately counter-productive, were apparently motivated by the goal of maximizing the distribution to the shareholder class. Some participants believed that the CEO resisted the original plan because he was seeking a "side deal," but we do not have credible evidence to confirm this rumor.

In Dreco Energy, the CEO was a management consultant hired by the board at the insistence of creditors. We classified this case as nonetheless aligned with shareholders, because the powers of initiative normally possessed by management were shared in this case with a major shareholder, who was the former CEO.

²⁴³ The two cases were Dreco Energy and Evans Products. Both had large shareholders as chairman of the board of directors.

²⁴⁴ See *supra* notes 221-22 and accompanying text.

²⁴⁵ These commentators are cited in LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 134 n.26.

²⁴⁶ See *id.* at 142 tbl. III col. 5. If two exceptional cases are excluded, the distribution to equity classes in insolvent cases ranged from 0% to 8.1% of the total

power and consistently exercised it in the interests of shareholders, we would expect the deviations to have been more substantial.²⁴⁷

Finally, substantial creditor influence over management can be inferred from the frequency with which significant corporate assets were liquidated. We found that in thirty of the forty-three cases in our study there was extensive liquidation of assets.²⁴⁸ Sometimes the business was sold as a unit. Sometimes it was sold off in pieces with the original entity retaining few assets other than tax losses (NOLs) that could be deducted against future profits. Most frequently, the company sold off large blocks of its assets during chapter 11 and reorganized with the remaining assets as a much smaller company. Liquidation of assets is in general, though not without exception,²⁴⁹ a reorganization strategy that favors creditor interests. In a forthcoming article, we report the data on liquidation and shrinking more extensively.²⁵⁰

value of the assets distributed to unsecured and equity classes under the reorganization plan.

²⁴⁷ We reported in our earlier study that one reason distributions were made to junior interests in violation of the absolute priority rule is that management sometimes held out in reorganization plan negotiations for such a distribution, even in cases in which no equity committee had been appointed at all. *See id.* at 150-52. That management sometimes holds out for distributions to equity under a reorganization plan does not establish that management is wholeheartedly committed to equity's welfare. If it were, the deviations from the absolute priority rule would probably have been much greater. But it does demonstrate that at least some managements were not totally indifferent to the welfare of shareholders.

²⁴⁸ *See infra* Table VIII accompanying note 290. In some cases, the actual liquidation took place post-confirmation, although it clearly was contemplated by all parties at the time of confirmation that liquidation would take place. Liquidation after confirmation avoids the necessity for bankruptcy court approval of the sales. *See* 11 U.S.C. § 363 (1988).

²⁴⁹ In Dresco Energy, for example, there was extensive liquidation of assets even though management's negotiating strategy was directly controlled by a major shareholder. Shareholder interests also received a substantial distribution under the reorganization plan—the largest deviation from the absolute priority rule in our study. *See* LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 142 tbl. III. Providing shareholders can be assured of a substantial distribution under the reorganization plan, liquidation of unproductive assets can be in the shareholders' interest.

²⁵⁰ *See* LoPucki & Whitford, *Patterns*, *supra* note 16.

D. *The Lack of Corporate Expansion*

Earlier in this Article, we demonstrated that the making of high risk investments that might sharply increase the value of the company during a reorganization case is generally in the interests of shareholders or junior creditors whose interests are underwater.²⁵¹ Such investments were relatively rare among the cases studied. Generally, these companies did not start new businesses, make acquisitions not integrally related to the company's existing business,²⁵² expand significantly the existing business,²⁵³ or engage in other high risk activity.²⁵⁴ There seemed to be a cultural norm that such investments were inappropriate for a company in reorganization.²⁵⁵ Several debtors had large amounts

²⁵¹ See *supra* notes 53-58 and accompanying text.

²⁵² While it was common for the debtor companies to be acquired by others during their reorganization cases, in only two instances did the debtors acquire other companies. Salant, a manufacturer of clothing, was permitted to acquire Claxtenport, which owned a process for putting creases in clothing. Air Florida, which had sold all of its assets to Midway Airlines, was encouraged by the court to acquire another airline company so that it could make use of its net operating loss carry forwards (NOLs). Air Florida acquired Pocono Airlines during the reorganization case.

²⁵³ Continental Airlines was the only company in our study that increased the size of its assets, sales, and employees during reorganization. The increase was controversial and the court restricted it. Interviewees told us that the controversy forced Continental to propose a plan and emerge from chapter 11 sooner than they otherwise would have.

²⁵⁴ There were two exceptions. The debtor in Sambo's Restaurants gambled and lost a large portion of the estate on new restaurant formats during reorganization. But that case was one of the few in which there was no substantial separation of possibility of gain from risk of loss. There was only a single level of debt, and equity was so far underwater that any distribution made to them probably would have been nominal even in the best circumstances. The unsecured creditors' committee, whose constituents had the great bulk of the possibility of gain and the risk of loss, approved the gamble.

Storage Technology completed development of a new product while in chapter 11, and the product was very successful. Its success enabled Storage Technology to become solvent before confirmation. Because of the company's solvency, creditors received post-petition interest under the reorganization plan. So this too ended up being a case in which creditors shared in the profits from the new investment.

²⁵⁵ Two incidents in cases from our study illustrate this norm. During the Continental Airlines case, the court refused to permit the debtor to buy United Micronesian Development Association, the controlling shareholder in Air Micronesia. The court stated: "The Code does not expressly prohibit the takeover of an independent corporation during the course of reorganization. There are, however, extenuating circumstances which render the attempted takeover of UMDA, under the aegis of the Bankruptcy Court (Texas), inconsistent with the equitable principles that pervade bankruptcy administration." *Continental Air Lines, Inc. v. Hillblom* (*In re Continental Air Lines, Inc.*), 61 B.R. 758, 783 n.49 (S.D. Tex. 1986).

of net operating loss carryovers and designed acquisition strategies as a way to utilize those carryovers. Nearly all of these debtors believed that they could pursue these strategies only after confirmation. Indeed, the desire to expand was cited as one reason to press for quick confirmation of a reorganization plan.²⁵⁶

Both the lack of corporate expansion and the frequency with which assets were liquidated are consistent with the view that creditors dominated the governance of these companies. Another observation, however, cuts in the opposite direction. In the early stages of the reorganization cases it was common practice for management to seek to maintain current business activities, often under the rubric of "preserving the company."²⁵⁷ The resulting delays provided an opportunity for upsurges in company fortunes that would serve the interests of shareholders and junior creditors, though that rarely happened.

Later in this Article, we argue that both the lack of expansion and the delays in liquidation result from a single principle of reorganization governance, which we call "prudent investment."²⁵⁸ For present purposes, it is sufficient to note that the practices of management with respect to delaying liquidations but

During the Manville case, creditors objected to the debtor's attempt to invest \$15 million in a joint venture in a platinum mine. The argument against court approval was that mining was "outside the company's main line of business—building materials." Sandra D. Atchison, *Platinum: The Birth of an American Industry*, BUS. WK., Jan. 27, 1986, at 64, 64. Near the end of the case, the creditors agreed to the venture and it was approved. See *Manville Receives Go Ahead for Mining Venture*, Business Wire, July 31, 1986, available in LEXIS, Nexis Library, Bwire File.

²⁵⁶ In both Wickes Companies and Salant, interviewees told us they thought the companies pressed to get out of reorganization as quickly as possible so that acquisitions could begin. McLouth Steel and White Motor were other cases in which the plan of reorganization contemplated acquisitions after confirmation. Both companies waited until after confirmation to begin. The exception was Air Florida. Like McLouth Steel, Air Florida disposed of all of its assets during the reorganization case. With the approval of all parties active in the case, the company then acquired Pocono Airlines prior to confirmation. The purpose of the acquisition was to preserve Air Florida's NOLs by satisfying any possible "continuity of business" requirement under tax law.

²⁵⁷ We concluded that in 25 of the 43 cases in our study there was at least one major asset sale at or before confirmation. In only nine of those 25 cases did the first sale occur in the first six months after filing. See *infra* Table VIII accompanying note 290. Much of the delay in the sale of major assets can be attributed to management's initial resistance to the break up of the company. During the early months of a case, management automatically enjoys exclusive authority to propose a plan, while the creditors' committee often is occupied with the tasks of organizing itself, hiring counsel, and the like.

²⁵⁸ See *infra* notes 340-49 and accompanying text.

avoiding business expansions in chapter 11 provide mixed evidence about the basic question of whose interests are being served. Like so much of the evidence presented above, they suggest that in some respects management puts the interests of creditors first, but that in other respects they do not.

E. *Summary and Assessment*

We used an unusual methodology in this study. It is somewhat akin to an anthropological study, in which an observer attempts a holistic explanation of a culture after immersion in it for an extended period of time. We have not exactly immersed ourselves in the forty-three cases we studied,²⁵⁹ but we have collected information from many sources, and we have attempted to characterize management behavior in a holistic way. This methodology has the weakness that the conclusions reached are dependent on our somewhat subjective judgments. We cannot be certain that if other researchers had done the same work, they would have come to the same conclusions. On the other hand, if research on corporate governance issues in bankruptcy is ever to expand beyond a priori theorizing based on untested assumptions,²⁶⁰ something like our methodology will have to be used. There are no evident objective tests for determining whose interests management advances in a complicated reorganization proceeding.

Our most dramatic empirical finding concerns the fragile tenure of CEOs of large, publicly held companies that reorganize. Tenure is especially fragile for CEOs we have labeled as tainted, virtually all of whom were replaced. Perhaps this should not be surprising. In the cases of insolvent debtors, equity classes seldom retained more than a small minority of the voting shares.²⁶¹ A change in

²⁵⁹ Cf. Stephen J. Sansweet, *Salvage Operation: How Team at Wickes Schemed and Cajoled to Restore its Health*, WALL ST. J., Aug. 2, 1985, at 1. A reporter actually sat in on many of the meetings in the Wickes reorganization and directly observed the formulation of management strategy, on condition that he write nothing of his observations until after confirmation.

²⁶⁰ The most egregious is the naive and widely shared assumption among bankruptcy scholars that reorganization managements represent shareholder interests. See *supra* note 8 and accompanying text.

²⁶¹ Of the 32 insolvent cases in our study, the equity class retained a majority of the reorganization shares in only two cases: Dreco Energy and Energetics. Though the old shareholders retained control of the emerging company in Energetics, they lost control of the large bulk of its assets. Energetics surrendered the assets to its major secured lender during reorganization, leaving the emerging company with

management is not an unusual occurrence when there is a shift in control of a large, publicly held company.

The *Douglas Report* on reorganizations of the 1930's painted a picture of excessive management discretion, often exercised in a very self-serving way. This criticism has recently been repeated in critiques of the current Code.²⁶² Our findings suggest some very real limits on the exercise of management discretion, however. One would expect that self-serving managements would ordinarily make preservation of their own jobs their first objective. Yet the CEOs in the companies studied were generally unable to accomplish even that. Nor were we able to detect any sizeable number of cases in which reorganization managers were able to convert their power as such into personal compensation, what we have called management "grabs." On the other hand, tainted managers often had enough leverage to negotiate releases from personal liability for possibly wrongful acts.²⁶³

As to whose interests management did serve, our basic conclusion is that management orientations were diverse. We do not mean to imply that management orientation was random. But it has been difficult to discover circumstances that partly or wholly determine the course followed by management over a number of cases.

We have made two findings of significance in this respect. First, shareholder interests were more likely to command the loyalties of management when an active shareholder held a controlling block of shares. Second, management's orientation was clearly a function of the company's solvency. The managements of solvent companies never aligned with creditors, while the managements of insolvent companies did so frequently. These alignments may partly account for the tendency for managements of insolvent companies to avoid risky investment policies and for deviations from the absolute priority rule to be limited.

We see two reasons to be concerned with the present state of affairs. First, there is tremendous uncertainty about how management is supposed to orient when it exercises the considerable authority extended to it by the Bankruptcy Code. Our

assets worth only \$3 million. Equity retained a majority of the reorganization shares in seven of the 11 solvent cases in our study. We report the percentage of shares retained by equity for each case in LoPucki & Whitford, *Patterns*, *supra* note 16.

²⁶² See *supra* note 10 and accompanying text.

²⁶³ See *supra* note 230 and accompanying text.

interviewees told us that managers frequently seek guidance on this issue, but attorneys find it difficult to provide well-grounded advice. Uncertainty in the law is not always a bad thing, but in this instance we can see no virtue in it.

Second, and more important, we are concerned that many managements are not acting to maximize the values of their firms. The problem is most obvious with respect to the decisions concerning the business plan. The tendency to avoid high risk investments generally serves the interests of senior creditors. The tendency to avoid quick liquidations generally serves junior interests. Neither necessarily serves the whole by maximizing the value of the firm.

Some commentators argue that maximization of firm value should not be the sole goal of bankruptcy policy.²⁶⁴ They assert that management should also seek to preserve the employees' jobs, the established business relationships between the company and its suppliers, and the welfare of the communities in which the company's operations are located. These goals are sometimes presented as expressing values different from the societal wealth maximization objective that underlies most economic analyses of law. But they can also be expressed as consistent with societal wealth maximization through the concept of externalization of costs. That is, if management considers only the value to the firm in deciding to discontinue and sell a business, many other "external" costs may be ignored, such as the cost to workers of finding new jobs or the disruption to local governments resulting from the reduction in their tax bases. A policy that only maximizes the estate available for distribution to creditors and shareholders may misallocate resources by not taking account of these externalized costs.

Concern for these externalities may counsel some allowance for management policies that do not maximize firm value. But the primary reasons managements are not maximizing firm value during reorganization are not the result of those concerns. Furthermore, the reasons we have discussed for why managements are not

²⁶⁴ See Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 732-39 (1991); Robert E. Scott, *Through Bankruptcy With the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690, 700-08 (1986); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777, 802-03 (1987). For a response to Warren, arguing that maximization should be the uniform criterion within bankruptcy (but not necessarily outside it), though apparently conceding that it is not in practice, see Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 816-22 (1987).

maximizing firm values may be the piece needed to solve the bankruptcy costs puzzle. Bankruptcy costs are commonly assumed to be very high.²⁶⁵ Yet it is clear that for large firms, the direct costs of bankruptcy, essentially professional fees, are relatively modest as a percentage of total assets.²⁶⁶ If bankruptcy costs are large, it must be because indirect costs are large. We think the most likely source of such substantial costs are non-maximizing corporate decisions that are made as a result of the corporate governance problems that we have discussed.²⁶⁷

IV. THE NOT-SO-UNEASY CASE FOR CORPORATE REORGANIZATION

In our view, the most fundamental problem of corporate governance is that of investment policy. So long as the company remains in reorganization, the risk of investment loss is borne largely by senior classes while the possibility of investment gain accrues largely to junior classes. This inclines the representatives of senior classes toward low risk investment and the representatives of junior classes toward high risk investments. In most cases, neither will have incentives that make them appropriate governors of

²⁶⁵ For extreme estimates of the magnitude of bankruptcy costs, see Bradley & Rosenzweig, *Untenable Case*, *supra* note 10, at 1068 ("Thus, in some general sense, the effect of the [Bankruptcy Reform Act of 1978] was to decrease stockholder wealth in listed firms alone by more than \$14 billion."); Robert H. Mnookin & Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco*, 75 VA. L. REV. 295, 297 (1989) (attributing a \$3.4 billion decline in the combined trading values of Texaco and Pennzoil stock to the threat of bankruptcy by Texaco and the resulting costs).

²⁶⁶ See Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 286 (1990) (estimating direct costs for publicly held firms at approximately three percent of assets). *But see* Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1077 (1984) (stating that the average ratio of direct bankruptcy cost to value of publicly held companies was six percent). This is not to say that the level of professional fees does not remain a substantial concern. See LoPucki & Whitford, *Venue Choice*, *supra* note 16, at 36-38, 45-47 (discussing courts' practices in the award of attorneys' fees and their effect on venue choice); Claudia MacLachlan, *Anger Rises Over Bankruptcy Fees*, NAT'L L.J., Mar. 9, 1992, at 1.

²⁶⁷ Managers of firms in bankruptcy frequently complain of the amount of time they must spend talking to lawyers, testifying in court, and the like, and this diversion of the time and energy of top management may be one reason why there are lost business opportunities. But management's inability to seize new investment opportunities because of the corporate governance imponderables that are the subject of this Article is more likely to be a major source of indirect bankruptcy costs. If the only problem is that the CEO is required to spend a great deal of time in court, the firm can hire other personnel to evaluate and pursue new investment opportunities.

investment policy. In the next part of this Article, we explain how we think these conflicting interests should be reconciled in contemporary reorganization cases. In this Part, we explore proposals to resolve the problem of investment policy by fusing the risk of loss with the possibility of gain through alteration of ownership interests shortly after filing, or even before a bankruptcy filing.

The most dramatic proposal of this nature calls for repeal of chapter 11.²⁶⁸ It asserts that marketplace contracting then would result in shares that terminated on default precisely at the time the company became insolvent. Termination of the stock would fuse the risk of loss with the possibility of gain in the hands of the class of creditors with the next lowest priority. One of us has critiqued this proposal in a separate publication.²⁶⁹ Suffice it to say that we do not believe capital markets work well enough to make practical this vision of a world without bankruptcy reorganization.

Another proposal for fusing the risk of loss and the possibility of gain is to require sale of the company at an auction shortly after the filing of the bankruptcy case. The purchaser at such an auction would pay cash and take the company free of the claims of creditors in the bankruptcy case. After the sale, the purchaser and those who provided the purchaser's financing would have the same incentives as other business owners to manage the assets efficiently. Presumably the financier would require that the risk of loss and the possibility of gain be united in the new owner. What we now call the business plan would be formulated and implemented by the new owner after the sale. The primary remaining function of the bankruptcy process would be to see that the proceeds of the sale were distributed to the former creditors and shareholders of the

²⁶⁸ See Bradley & Rosenzweig, *Untenable Case*, *supra* note 10, at 1078-89. Their proposal draws heavily on a proposal by Bebchuk. See Bebchuk, *supra* note 8, at 781-97. While the Bebchuk proposal differs in detail, it also presumes extraordinarily well functioning capital markets. See Lynn M. LoPucki, *Stakeholders in Bankruptcy: Some Comments*, 43 U. TORONTO L.J. (forthcoming summer 1993) (criticizing Bebchuk's proposal).

²⁶⁹ See Lynn M. LoPucki, *Strange Visions in a Strange World: A Comment on Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992).

failed firm.²⁷⁰ On this question management could be required to remain neutral.²⁷¹

Something like this change in reorganization practice was suggested several years ago by Professors Douglas Baird and Thomas Jackson in separate publications.²⁷² Each suggested that it might be more efficient to liquidate failed companies by auction to the highest bidder than to reorganize them. Because their proposals were motivated primarily by a desire to avoid the need for judicial valuation of the firm or, alternatively, negotiations over reorganization plans that would deviate from the absolute priority rule,²⁷³ they did not explicitly address the issue of the timing of the sale.²⁷⁴ But if sales of assets are to avoid the troublesome

²⁷⁰ This is a function that a chapter 11 reorganization plan could accomplish, though it could also be accomplished through a chapter 7 proceeding. In chapter 7, the proceeds are distributed strictly according to the absolute priority rule, without the need to confirm a reorganization plan. See 11 U.S.C. §§ 507, 726 (1988 & Supp. III 1991). The advantage of distribution under chapter 7 is that it saves the transaction costs of soliciting votes under chapter 11. Furthermore, it prevents underwater interests from using the difficulty of obtaining those votes or confirming a chapter 11 plan by cram down to negotiate a small distribution for themselves as their price for a consensual plan. See LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 143-58. On the other hand, as presently constituted, chapter 7 requires the automatic appointment of a trustee. See 11 U.S.C. § 701 (1988). This feature could be seen as unattractive and unnecessarily costly, if incumbent management can be trusted to oversee the distribution of the sale proceeds. If incumbent management resigns, however, appointment of a trustee may be no more burdensome than the hiring of new management.

²⁷¹ Concern about the suitability of the future financial structure of the company is commonly cited as a justification for management involvement in negotiations about the size and nature of the distributions under the plan of reorganization. That concern disappears with the sale of the business.

²⁷² See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 209-24 (1986); Douglas G. Baird, *The Uneasy Case For Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 136-45 (1986).

²⁷³ See JACKSON, *supra* note 272, at 211 ("What differs in the situation in which the firm is sold to its own claimants in a reorganization is that the valuation of the proceeds out of which the claims against the debtor are to be paid is more difficult."); Baird, *supra* note 272, at 136-37 ("Unlike the competing third-party buyers, a bankruptcy judge enjoys no benefits and suffers no costs if he under- or overvalues a firm. A bankruptcy judge may be less able to cast a cold eye on an enterprise . . . than someone who has put his own money on the line.").

²⁷⁴ In his original proposal, Baird contemplated that the sale of assets could be in part, rather than a unitary sale, and that the sale could take place over a considerable period of time. See Baird, *supra* note 272, at 137. Thus, Baird clearly did not contemplate that the sale would take place at the time of filing. At one point, Jackson touched on avoidance of the corporate governance problems with which we are concerned as a reason for making the sale of assets the essential feature of a chapter 11 reorganization:

corporate governance issues that are the subject of this Article, they must occur soon after the automatic stay takes effect. Recognizing this, Baird has recently "revisited" his proposal, advancing it explicitly as a solution to the corporate governance problems addressed in this Article and acknowledging that a sale shortly after filing would be necessary.²⁷⁵

Advocates of the proposal for an immediate, mandatory auction must solve the complex problem of "triggering" the filing of the reorganization case.²⁷⁶ In its current operation, the bankruptcy system relies heavily on voluntary filing. That is, management initiates the case.²⁷⁷ If filing led immediately and inevitably to a sale of the company, there is every reason to believe that the current process for triggering reorganization would fail.²⁷⁸ Purchasers usually replace the managers of the companies they purchase.²⁷⁹ Managers would know that filing for reorganization

For firms that are insolvent, diverse ownership creates vastly different incentives for different groups of owners. Specifically, it is in the interests of shareholders to delay. Any event that fixes values today, such as a sale of assets . . . leaves them with nothing as their baseline entitlement. When a group has nothing to lose by delay, that group will in fact favor delay. Much of the law of bankruptcy must concern itself with that incentive. . . . No . . . device, however, exists (or can be readily devised) to require shareholders to compensate unsecured creditors for the costs of delay. Accordingly, if things turn out worse, the creditors pay for it. If things turn out better, the unsecured creditors may get some of those benefits, but they do not get them all.

JACKSON, *supra* note 272, at 216 (footnote omitted). However, nowhere did Jackson discuss the problems with arranging the quick sale that would be needed to avoid corporate governance problems.

²⁷⁵ See Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. (forthcoming April 1993).

²⁷⁶ See generally Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223, 223-25 (1991) (discussing the problems associated with creditor initiation of bankruptcy proceedings and arguing that such authority remain vested with management); LoPucki, *supra* note 53, at 343-48 (advocating that the triggering problem be solved by encouraging creditors to file involuntary petitions against debtors).

²⁷⁷ Only about one half of one percent of all bankruptcy cases are filed by creditors. See Baird, *supra* note 276, at 224 n.4. The proportion may be higher for larger cases. Six of the 43 cases in our study (14%) were initiated by involuntary petitions: Amarex, Baldwin-United, Energetics, FSC, Marion, and Seatrain Lines. The difficulties of initiating an involuntary case are discussed in LoPucki, *supra* note 53, at 363-65.

²⁷⁸ Easterbrook also offers this reason for rejecting a system of mandatory auctions shortly after the filing of a chapter 11 petition. See Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 415 (1990).

²⁷⁹ This was the usual though not inevitable practice in the cases we studied in

was generally equivalent to resigning their offices. The low filing rates under chapter X of the Bankruptcy Act suggest that in such circumstances managers choose not to bring their companies into bankruptcy.²⁸⁰ It was largely because of this triggering problem that Congress decided to return to the pre-1939 practice of allowing management to remain in office after the filing of a reorganization case.²⁸¹

This is not to say that managers must be assured that they will remain in office indefinitely. To the contrary, we found that under current practice, a substantial portion lose their jobs by the end of the case.²⁸² But to the management of a company in financial crisis, the difference between immediate, virtually certain loss of control under a mandatory quick sale procedure and the slow squeeze that will force most of them from office under the current procedures is critical. To file for reorganization under the current practice is risky. But it is usually an acceptable alternative because it offers management the probability of a "soft landing." That is, even after filing, management probably will have the time and the leverage to negotiate a severance arrangement. But in a system where quick sale of the business was mandatory, the bulk of that leverage as well as the time in which to negotiate a deal would disappear. Ironically, therefore, without the delay built into current chapter 11 practice, the *filing* of many bankruptcy cases would be delayed. It is generally assumed that further delay in initiating

which there was a substantial sale of assets. *See supra* note 59.

²⁸⁰ The total number of chapter X proceedings filed in the 1978 and 1979 fiscal years, the last two fiscal years (ending on June 30) before the Bankruptcy Act was repealed, was 75 and 63 respectively. *See* 1978 & 1979 ANNUAL REPORTS OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF U.S. COURTS tbl. F-2, in REPORTS OF THE PROCEEDINGS OF THE JUDICIAL CONFERENCE OF THE UNITED STATES FOR 1978 AND 1979. Not all of these cases involved publicly held companies. By contrast, under chapter 11 of the Bankruptcy Code, filings by publicly held companies averaged over 100 per year between 1985 and 1990. *See* Securities & Exchange Comm'n, *supra* note 14.

²⁸¹ *See, e.g.*, HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. NO. 595, 95th Cong., 1st Sess. 231 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6191 ("Proposed chapter 11 recognizes the need for the debtor to remain in control to some degree, or else debtors will avoid the reorganization provisions in the bill until it would be too late for them to be an effective remedy."); *id.* at 233 ("Debtors' lawyers that participated in the development of a standard for the appointment of a trustee were adamant that a standard that led to too frequent appointment would prevent debtors from seeking relief under the reorganization chapter, and would leave the chapter largely unused except in extreme cases.").

²⁸² *See supra* Table IV accompanying note 190; *supra* Table V accompanying note 203.

bankruptcy for insolvent firms is likely to increase the overall losses suffered by creditors and shareholders.²⁸³

A second problem with substituting a mandatory quick sale of the business for a reorganization is that the sale may not bring an appropriate price. The existence of bankruptcy reorganization procedures is commonly premised on the existence of a difference between the going concern value of the firm and its liquidation value, that is, the amount for which it can be sold. The purpose of establishing a reorganization procedure is to allow the claimants on the firm, creditors and shareholders together, to capture that difference for their own benefit by paying themselves with securities of the reorganized firm rather than the proceeds of an outright sale.²⁸⁴ Proponents of an immediate auction essentially call into question the fundamental assumption that for large, publicly traded firms there can be a substantial difference between the going concern and liquidation values. Given the prevalence of investment banking firms, and the widespread acceptance of the efficient capital markets hypothesis, these proponents doubt that a firm can be worth more as an continuing entity than what some outsider would be willing to pay for the firm in its entirety.²⁸⁵ The

²⁸³ See H.R. REP. NO. 595, *supra* note 281, at 233-34 ("One of the problems that the Bankruptcy Commission recognized in current bankruptcy and reorganization practice is that debtors too often wait too long to seek bankruptcy relief."); ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS* 887 (2nd ed. 1991); Bulow & Shoven, *supra* note 53, at 455; LoPucki, *supra* note 53, at 333-43. Once it is clear that a company is unable to restructure privately, it is often best that it file bankruptcy immediately to gain the benefits of the automatic stay. Otherwise, management is likely to make unfortunate bargains to avoid execution on important assets. See generally JACKSON, *supra* note 272, at 7-19 (rationalizing bankruptcy as a solution to the common pool problem).

²⁸⁴ See generally Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1250-54 (1981) (discussing the historical evolution of bankruptcy reorganization procedures and emphasizing the desire to capture the difference between going concern and liquidation values of the firm for the benefit of creditors).

²⁸⁵ As Baird has noted:

[In the event of reorganization] the owners would spare themselves the expense of searching for an actual buyer. But these savings may not be substantial. The ability investment bankers have shown to take large firms public (such as the Ford Motor Co. or Apple Computer) and the willingness of others to acquire firms for huge sums (such as General Motors' multibillion dollar purchase of Hughes Aircraft) suggest that it is possible to sell the assets of even giant corporations to third-party buyers.

Baird, *supra* note 272, at 140-41. Baird and Jackson recognize that for their proposed system to be an adequate substitute for reorganization, the outsider must be able to purchase everything of value that the firm currently possesses, and that currently some legal rules inhibit the sale of some attributes. Baird and Jackson's solution to

acquiring party might raise the necessary capital through borrowing or through the issue of a new stock offering.

Our interviewees were skeptical that large, publicly held companies in reorganization could be sold for their going concern value, particularly if the sales had to take place shortly after filing.²⁸⁶ Many of the businesses were suffering massive losses at the time they filed.²⁸⁷ Until such losses can be brought under control, reliable estimates of going concern value will be difficult to make.²⁸⁸ Potential purchasers will find it hard to acquire the information needed to evaluate the firm accurately, which will depress the price.²⁸⁹ Consistent with this view, when there was

that problem is to advocate change in the latter rules. For example, they would make tax loss carryovers fully transferable to a purchaser of the firm, so that reorganization would not be the only way to realize the value of these tax benefits. See JACKSON, *supra* note 272, at 224 (“[T]his solution would require changes in the legal rules . . . to permit what occurs in the operation of the business in chapter 11 to occur with equal ease in chapter 7.”); Baird, *supra* note 275, at 9; Baird, *supra* note 272, at 146-47 (“The trustee should be able to transfer to a third-party buyer not merely all tangible assets of the firm but also the intangible ones . . .”).

²⁸⁶ Our interviewees were predominantly lawyers who specialized in chapter 11 practice and can be thought to have a vested interest in opposing a proposal to abort the proceedings that bring their current income. Although they may be a biased sample, they are also an informed sample. Moreover, as discussed in the text, substantial corroboration exists for their point of view.

²⁸⁷ See Table I, *supra* note 25 (26 of the 41 companies for which data are available reported losses before filing).

²⁸⁸ Time may also be needed to clarify and perhaps resolve some uncertain potential liabilities that necessarily must be passed along to a purchaser of the assets, such as potential environmental liabilities imposed on the owner/operator of the assets. Nor is it always easy to value the unique rights, such as the option to assume or reject leases and executory contracts, that come into existence only upon the filing of a bankruptcy case.

²⁸⁹ The problem is essentially one of information differential. Even those in control of a firm in financial chaos do not have complete knowledge of its worth. But they usually have much better information than potential purchasers. Even if they do not, the potential purchasers have no way of knowing that. As Baird correctly points out, the sellers of such a firm have a problem that can be viewed as either one of credibility or communication. The very fact they have chosen to sell communicates to the buyer that “the fortunes of the firm [are] bleaker than they otherwise [appear].” Baird, *supra* note 275, at 15.

Baird would resolve the problem by forcing the sale of all firms, thus hopefully eliminating the implication that any firm that is for sale is a lemon. We do not think his solution can work. First, eliminating the choice to keep or sell a firm that has filed for reorganization does not eliminate the choice to keep or sell a firm. Management will still have the ability to decide whether to put the firm in bankruptcy. And the choice to put a firm into a procedure that inevitably leads to a sale rightfully will suggest that “the fortunes of the firm [are] bleaker than they otherwise [appear].” *Id.* Large, publicly held companies usually have considerable discretion as to when and whether to file. Many of the assets of companies we

a sale of all or most of the assets of a firm in our study, it commonly occurred more than a year after filing.

TABLE VIII
ASSET SALES

Name of Case	First Purchaser of Major Asset ²⁹⁰	Time between Filing and First Sale of Assets ²⁹¹ (in months)	Time between Filing and Substantial Liquidation ²⁹² (in months)
Air Florida	Midway	2	2
Amarex	Templeton	33	33 (at confirmation)
Baldwin-United	Security Pacific	9	13
Braniff	People's Express	10	10
Charter	Metropolitan Life	9	
Dreco	Mud Solids Engineering	15	
Energetics	ITR Petroleum	8	8 (at confirmation)
Evans Products	Evans City Steel*	3	
FSC	Crystal Oil	5	
Itel	Insufficient Information		

studied were unencumbered at filing; the managers could have bought additional time by granting security in these assets.

The credibility problem cannot be solved by forcing the sale of all firms that file. It can only be solved by giving buyers a meaningful opportunity to inspect and evaluate the company. As a practical matter, we think that means stabilizing the firm to the point where potential purchasers can learn nearly as much about the firm as its current owners and managers know.

²⁹⁰ In three instances, indicated by an *, we were unable to identify the name of the purchaser. We have substituted a description of the assets sold.

Because we were frequently unable to obtain specific information about the sales price for an asset sale, we could not formulate an objective standard for what constitutes a "major" asset sale. Consequently, we have relied on our subjective judgment in concluding which asset sale should be considered major.

We do not report in this Table cases in which a purchaser acquired a controlling block of the company's shares rather than purchase its assets directly. However, such transactions can often have the same effects as asset purchases. In these cases in which such transactions occurred, there was typically a delay between filing and the purchase of a controlling share block.

²⁹¹ Wherever possible we have reported the date on which the sale was agreed to, but in some cases we have had to rely on the date on which the court approved the sale or the sale was consummated, since that was the only information available to us. Consequently, these time periods should be considered approximate.

²⁹² For many cases, we were unable to obtain specific information about the value of assets sold or the value of assets remaining in the company. Hence our judgment about whether a company substantially liquidated is subjective. For further information on reduction in asset size while in chapter 11 for companies in our study, see LoPucki & Whitford, *Patterns*, *supra* note 16.

KDT	Ames	16	16 (at confirmation)
Lionel	Vishay Intertechnology	43	43 (at confirmation)
McLouth	Cleveland-Cliffs	7	11
MGF	Southmark	36	36 (at confirmation)
NuCorp	Trico Industries	8	
Penn-Dixie	Cement Assets*	8	
Pizza Time Theatre	Show Biz	5	13 (at confirmation)
Revere	Noranda	27	
Sambo's Restaurants	Vicorp	32	32 (at confirmation)
Saxon	Copystatics	6	35 (at confirmation)
Seatrains Lines	Abilene-Pride	5	5
Smith International	Cameron Iron Works	19	
Technical Equities	Brown & Tanik*	3	17 (at confirmation)
Towle	Town & Country Jewelry	3	18 (at confirmation)
White Motor	White Farm USA	3	34
Wickes	Pillsbury	1	

Some of the delay was occasioned by disagreement among the various parties about whether to conduct a sale or to reorganize.²⁹³ But some of the delay was also occasioned by the perceived need to "structure" the firm so that the maximum bid could be received.²⁹⁴

Auction theory²⁹⁵ also lends credence to skepticism about the

²⁹³ We judged that in 16 of the 43 cases in our study, all or most of the assets were sold at or before confirmation. The average time elapsed between filing and liquidation was over 18 months. In 10 cases the last major transaction occurred at confirmation. The average time elapsed between filing and confirmation for these 10 cases was over two years. *See supra* Table VIII accompanying note 290. In those cases, concern that liquidation could only be approved as part of the plan confirmation process may have influenced the timing of the sale. *See supra* notes 142-44 and accompanying text. For this reason they may not be the best surrogates for estimating how quickly sales could take place under a scheme requiring an immediate, unitary sale of assets.

²⁹⁴ In the six cases in which the liquidating sale occurred before confirmation, the time period from filing to completion of the sale that substantially liquidated the corporation varied greatly but averaged over twelve months. *See supra* Table VIII accompanying note 290. While theoretically some of this delay may have been occasioned by management resistance to the idea of liquidation, in fact in all of these six cases the decision to liquidate was reached very quickly. Virtually all of the delay was occasioned by the time needed to arrange an advantageous sale by a management committed to liquidation of the assets as a business plan for the company.

²⁹⁵ A good introduction to, and bibliography of, auction theory appears in Bruce

ability of a quick auction sale process to realize the full going concern value of the firm. Because many businesses are incurring losses,²⁹⁶ potential purchasers will need to develop a business plan for the company before they can estimate the level of profitability the reorganized company could achieve. They may need to obtain financing for the purchase and perhaps pay a commitment fee for that financing. An outsider will not incur these costs unless it has reason to believe that it can buy the assets at a price sufficiently below their going concern value (hereinafter called the "differential") to cover both the costs of preparing a bid and the risk that it will not be accepted. There is reason to believe that the size of this differential is substantial. Today, firms that wish to attract bids for large blocks of assets often must offer incentives to persuade a potential purchaser to make the expenditures that are a prerequisite to bidding. The most common incentives are in the form of a contract for the seller to pay a "breakup" or "topping" fee to cover the cost of preparing a bid that is topped by a later bidder.²⁹⁷ That such incentives are often substantial suggests that the cost of preparing a bid, and therefore the amount of the "differential," is substantial.²⁹⁸ This amount could be captured

A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 107-11 (1991).

²⁹⁶ See *supra* note 287 and accompanying text.

²⁹⁷ See Bruce A. Markell, *The Case for Banishing Breakup Fees From Bankruptcy*, 66 AM. BANK. L.J. (forthcoming Fall 1992); Howard J. Berman, *Using Bidding Incentives in Bankruptcy Asset Sales*, N.Y. L.J., May 9, 1991, at 5; J. Hayden Kepner, Jr., *Breakup Fees and Overbid Amounts (Reported Cases)*, Bankr. Ct. Dec. (CRR) A7 (Apr. 30, 1992) (table showing breakup and overbid fees approved by courts in 20 cases); see also *In re Integrated Resources, Inc.*, 135 B.R. 746, 753 (Bankr. S.D.N.Y. 1992) (authorizing a breakup fee of \$6 million); *Twenver, Inc. v. MCA Television, Ltd. (In re Twenver, Inc.)*, 127 B.R. 467, 468-69 (D. Colo. 1991) (authorizing commitment to make a topping fee payment to a bidder if the bid proved unsuccessful). As explained by the creditors' committee that sought authorization for the debtor to pay a topping fee in the Twenver case:

[A] topping fee, or breakup fee, is a fee paid to an initial bidder for the assets of the Debtor if the bidder, after performing its due diligence inquiry, is outbid by a second bidder. Such a fee is a necessary and appropriate means to compensate a prospective purchaser of a Chapter 11 debtor's assets for the time and expenses of performing the "due diligence" analysis and for the risk of being a "stalking horse" in the sale of the Debtor's business. Such a bidder runs the risk of ultimately being outbid for the business by another entity which derives an unfair benefit from the due diligence performance and the commitment of the first bidder to purchase the business at a stated price.

Id. at 468 (citations omitted).

²⁹⁸ The breakup and topping fees that exist today are offered when bids are

by creditors and shareholders were they to reorganize the company rather than sell it at auction.

For the proposed auction to render moot the problem of corporate governance, the firm must be required to sell to the highest bidder, regardless of the adequacy of the bid. Otherwise, the conflicts between senior and junior interests would reemerge when deciding whether to accept the highest and best bid.²⁹⁹ To warrant reliance that the marketplace is going to yield an adequate price,³⁰⁰ at least two credible outside bidders must exist.³⁰¹ Several of our interviewees expressed the view that capital markets are not sufficiently developed to produce enough bidders to ensure that the winning bid will approximate the going concern value of

solicited for sales that occur long after filing. Because of the greater uncertainty about the future value of the company that exists at the time of filing, as discussed earlier in the text, it makes sense that the size of these incentives would need to be greater to solicit bids at that time, to cover the costs of the increased investigation that must precede the bid.

²⁹⁹ Acceptance would generally be in the interests of senior interests; rejection and continuance of the reorganization case would favor junior interests.

³⁰⁰ There is a substantial debate in the literature whether it is sound public policy to encourage tender offers for solvent firms that approximate the amount that would be bid in a fully competitive auction. Some believe that shareholders are entitled to the "full value" of their shares, even if it exceeds their current trading value, and consequently, that measures to encourage fully competitive tender offers are appropriate. Others believe that successful tender offers at bargain prices will encourage greater search for firms whose shares are undervalued and that this behavior will have several desired effects, including more frequent removal of incompetent management. Compare Lucian A. Bebchuk, *The Sole Owner Standard For Takeover Policy*, 17 J. LEGAL STUD. 197, 198 (1988) (favoring measures to guarantee shareholders' full value in some circumstances) and Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices As an Acquisition Motive*, 88 COLUM. L. REV. 891, 901-20 (1988) (same) with Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 3 (1982) (opposing auctions in response to initial tender offer) and Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165, 195 (1988) (same).

With respect to insolvency reorganizations, we assume that public policy favors bids at the prices that would be achieved in fully competitive auctions. Unlike the takeover situation, there is no need to offer extraordinary returns as rewards for searching out firms that can be bought at a profit, because the bankruptcy process is not initiated by the bidders. Moreover, the beneficiaries of higher prices will mostly be unsecured creditors. Consequently, ensuring adequate prices in chapter 11 auctions might lower the cost of credit to companies.

³⁰¹ In making this statement, we assume that a sole bidder would know that it is the sole bidder. Some auction methods, particularly those involving sealed bids, attempt to conceal from a sole bidder the fact that it is a sole bidder. But in the sale of a large business, where the number of potential bidders is small and pre-bid investigation must be extensive, we doubt that the agent conducting the auction could prevent a sole bidder from discovering its status as such.

the firm less the "differential." Sizeable businesses were sold in many of our cases, but none of the purchases were financed through an initial public offering.³⁰² The successful bidder was, in every instance, an already existing firm, usually one in the same line of business. This suggests that for most large businesses, only a limited number of potential buyers exists.³⁰³ Despite the questionable legality of such an agreement,³⁰⁴ the number of potential bidders may be further reduced by the formation of joint ventures among them.³⁰⁵ In five of the cases studied, the debtor

³⁰² Easterbrook points to the cost of a public offering in commenting on the lack of such offerings to finance the takeover of reorganizing firms. See Easterbrook, *supra* note 278, at 415. The impracticality of making a public offering while in reorganization under chapter 11 is discussed in LoPucki, *supra* note 269, at 100 n.78.

³⁰³ See PAUL ASQUITH ET AL., ANATOMY OF FINANCIAL DISTRESS: AN EXAMINATION OF JUNK BOND ISSUERS 15-19 (National Bureau of Economic Research Working Paper No. 3942, 1992); Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992). Both papers suggest that the prospective buyer of the assets of a large company in financial distress with the highest use value for the assets is likely to be another company in the same field. But because economic conditions in the industry in which the distressed firm operates are likely to be poor, other firms will have difficulty obtaining the credit needed to bid strongly for the assets. Consequently, they suggest, reorganization may provide a higher return to the distressed firm than sale of the assets.

³⁰⁴ See 11 U.S.C. § 363(n) (1988).

³⁰⁵ In HRT Industries, some months after filing, management agreed with the creditors' committee to solicit bids from outsiders for purchase of the firm, a department store chain. One bid was received from Schottenstein Stores, another department store chain. The creditors found the bid minimally acceptable. But while a reorganization plan was being negotiated based on that bid, a higher bid was submitted by McCrory, another department store chain. At that point there was a prospect of competitive bidding between the two. This possibility was nipped in the bud, however, when McCrory and Schottenstein formed a joint venture. On a take it or leave it basis, they submitted a common bid equal to the McCrory bid. With no other bidders readily evident, the creditors' committee and management decided to accept this bid. The equity committee vigorously opposed the bid, which was not high enough to provide for a distribution to them under the absolute priority rule. They attempted, without success, to solicit a higher bid from some other outsider, but the equity committee was laboring in a circumstance in which management and the creditors' committee were committed to support the joint venture's bid. Potential bidders must have been reluctant in such circumstances to commit the resources to prepare a bid, knowing there was a good chance it would be unsuccessful even if higher than the pending bid. Ultimately, a plan of reorganization based on the joint venture bid was crammed down over equity's objection.

Later events showed that the joint venture made a large profit. Reorganization shares traded immediately after confirmation at \$6.75 per share. The joint venture paid in cash \$3.72 per share for their controlling block. Even before the effective date of the plan, McCrory obtained an option, later exercised, to acquire Schottenstein's part of the joint venture's holdings at about \$5.50 per share, giving the latter a quick \$4.2 million profit. Within the next year, McCrory took the

was able to conclude a sale even though only one seriously interested buyer came forward.³⁰⁶ In those cases, the debtor's ability to decline to sell, and instead reorganize under an internal plan, must have been of critical importance in giving it the leverage needed to negotiate an adequate sale price.³⁰⁷

A final reason why it may be less efficient to sell companies in chapter 7 than to reorganize them under chapter 11 is the possibly high direct cost of the former. Presumably the sale of a large, publicly held company in chapter 7 would be conducted in much the same way as in the absence of bankruptcy: the services of an investment banker would be employed. When the fees of the investment banker are considered, the cost of liquidating under chapter 7 may exceed the cost of reorganizing under chapter 11.³⁰⁸

company private, paying minority shareholders \$6 per share. *See generally M&S Joint Venture Bids for Remainder of HRT's Shares*, WALL ST. J., Oct. 5, 1984, at 16; *McCrorry Gets Option to Buy 27.5% More of HRT Industries*, WALL ST. J., Mar. 15, 1984 at 16; *Rapid-American Acquires HRT*, WALL ST. J., Apr. 23, 1985, at 55.

³⁰⁶ Pizza Time Theatre (acquired by its competitor, Show Biz); Air Florida (most assets acquired by Midway Airlines); Amarex (acquired by Templeton, another energy company); Energetics (acquired by ITR, a secured creditor). A particularly instructive case was McLouth Steel. The debtor contracted to sell some of its steel capacity to a competitor, Jones and Laughlin. The Antitrust division of the Justice Department tried to compel the debtor to sell to someone else, but eventually acknowledged that there were no other interested parties. By then, Jones and Laughlin had withdrawn. Early in that case, the debtor sold its trucking operation back to the entrepreneur from whom the debtor had purchased it. There was one other interested buyer, but that buyer withdrew before a sale could be negotiated. For the company's remaining major assets, the steel mills, it hired an investment banker to find potential buyers. Only one, Tang Industries, could be found. The company closed a sale to Tang.

³⁰⁷ In other cases, attempts to sell assets were abandoned because no serious bidders could be found. These included Storage Technology (sale of the entire company); Revere Copper & Brass (sale of an aluminum reduction plant in Alabama); and FSC Corporation (sale of the entire company).

³⁰⁸ Both Baird and Eisenberg suggest that the direct costs of auctioning a company may exceed the direct costs of reorganization because of the very high fees customarily charged by investment bankers. *See Baird, supra* note 275, at 9-10; Eisenberg, *supra* note 78, at 33-34. Although that may be true, the reasons are not clear. Investment bankers already participate in many chapter 11 cases. In our study, creditors' committees hired investment bankers in at least 16 cases and equity committees did so in at least seven. Debtors consulted investment bankers even more frequently, but we did not systematically collect this information from debtors. When investment bankers do participate, typically one of their tasks is to investigate and advise on the available options, which includes selling the company in its entirety.

Consequently, it is possible that much of the work that an investment banker would have to do in an auction is already done in chapter 11, and it may be done by several sets of investment bankers rather than just one. If so, it is hard to see why investment bankers' fees in an auction should be higher than the direct costs of a

In this Part, we have emphasized the need for the sale of assets to occur shortly after filing, because only a quick sale could render moot the problems of corporate governance. If, as originally proposed by Baird and Jackson,³⁰⁹ the sale could be made months or years after filing, several of the difficulties we have raised would be ameliorated. Managers' fear of chapter 11 would be reduced, because they would know that even after filing they still would have time to negotiate for a soft landing. Through the ability to conduct auctions with reserve and to offer bidding incentives, the debtor would have a better chance of prompting truly competitive bidding. If an auction were conducted after implementation of a business plan, a prospective purchaser may find it easier to obtain reliable information about the firm's prospects, reducing the extent to

reorganization. However, it is possible that an investment banker would have to do much more work to sell a company in a speedy auction than we realize. Baird suggests that the high costs of auctions may be attributable to the costs of complying with securities law. *See* Baird, *supra* note 275, at 10. The Bankruptcy Code exempts a chapter 11 plan from the securities law. *See* 11 U.S.C. § 1145 (1988).

TABLE IX
INVESTMENT BANKERS EMPLOYED BY CREDITOR OR EQUITY COMMITTEES

Name of Case	Creditors' Committees	Equity Committees
AM International	yes	
Anglo Energy	yes	yes
Baldwin-United	yes	
Charter	yes	yes
Continental Airlines	yes	
Cook-United	yes	
Evans Products	yes	
HRT	yes	
Johns-Manville Corp.	yes	yes
Revere		yes
Salant	yes	yes
Saxon	yes	
Seatrains Lines	yes	
Smith International	yes	yes
Storage Technology	yes	
White Motor	yes	
Wickes	yes	yes
TOTAL	16	7

³⁰⁹ *See supra* note 274 and accompanying text.

which information deficits lower the bid.³¹⁰ The problem of shareholder-creditor conflict regarding investment policy during the period preceding the auction would remain.³¹¹ However, the sale price could be deemed to be the value of the company, thereby ameliorating the problem of allocating reorganization values between shareholders and creditors.³¹²

We have pointed out a number of problems and costs inherent in requiring a quick sale of reorganizing firms. Problems and costs arise in the current process as well.³¹³ Which set of problems and costs is greater is ultimately an empirical question for which we have no answer. The proposal for an immediate, mandatory, unitary sale of assets, however, would work a radical change in current reorganization practice.³¹⁴ Because such a change is not imminent, the question for whom management should govern during the pendency of the bankruptcy case will remain pertinent. We turn next to that question.

V. FOR WHOSE BENEFIT SHOULD MANAGEMENT GOVERN?

In Part II of this Article, we described the processes by which shareholders and creditors compete for the loyalties of management. Our description demonstrated that these processes were too complex and haphazard to support a prediction of a consistent pattern of management loyalty during reorganization. In Part III, we presented empirical data on the manner in which managements divided their loyalties among the interests of shareholders, creditors, or themselves. Our data showed considerable variation from case to case. That variation mirrors the lack of generally accepted norms regarding the duties of reorganization management. In this

³¹⁰ See *supra* note 289 and text accompanying note 296.

³¹¹ A sale of all assets ends this conflict, and perhaps more quickly than reorganization. See *infra* note 378.

³¹² That is, sale of the company for cash would greatly reduce the leverages that are one reason that holders of underwater claims and interests can typically negotiate deviations from the absolute priority rule in their favor. The leverages are discussed in more detail in LoPucki & Whitford, *Preemptive Cram Down*, *supra* note 16, at 628-33.

³¹³ See *supra* note 267 and accompanying text.

³¹⁴ Under current practice, managers who want to sell assets immediately upon filing may be able to do so if they have an "articulated business justification." See *supra* notes 141-42 and accompanying text. But managers who do not want to sell the assets are generally protected by exclusivity. See Table III, *supra* note 177. Other considerations, such as the preservation of tax NOLs through reorganization, would make it difficult to change the practice without enabling legislation.

Part we consider for whose benefit management should govern and also discuss what mechanisms could insure that management behaves in desired ways.

Management loyalty can affect the content of both business and reorganization plans. We will focus primarily on the business plan, however, particularly the central element of investment policy during reorganization. We believe that management has greater influence over investment policy than they do over the reorganization plan.³¹⁵ Moreover, the normative question of how management should behave with respect to the reorganization plan is somewhat easier to answer, for reasons we will indicate later.³¹⁶

A. *Management as Representative of Shareholders*

Some commentators have asserted that insolvent, reorganizing companies should be governed for the benefit of their shareholders.³¹⁷ We disagree. Because shareholders bear little of the risks of loss in the context of insolvency, they have a bias in favor of high risk investments.³¹⁸ In bankruptcy, the bias is especially strong because the shareholders face cancellation of their interests at confirmation. Unless the corporation's fortunes are reversed very quickly, they are likely to receive little or nothing under the plan. Even a modicum of commitment to wealth maximization as a normative principle should make one uncomfortable with leaving the management of an insolvent corporation in the control of shareholders with such incentives.³¹⁹

When insolvent companies make risky investments in the interests of shareholders, creditors bear the losses. So long as those

³¹⁵ We discuss our empirical findings about the extent of management influence over the content of reorganization plans in LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 149-52.

³¹⁶ See *infra* notes 356-58 and accompanying text.

³¹⁷ This seems to be the view of Budnitz, *supra* note 94, at 1233-34; see also Gerber, *supra* note 94, at 343-44 (arguing that governing for the benefit of stockholders does not contravene federal bankruptcy policy). *But see* Skeel, *supra* note 7, at 463-64.

³¹⁸ This analysis is presented *supra* notes 53-58 and accompanying text; see also Easterbrook & Fischel, *supra* note 9, at 404 ("When the firm is in distress, the shareholders' residual claim goes underwater, and they lose the appropriate incentives.").

³¹⁹ See, e.g., *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del Ch. LEXIS 215, at *108 n.55 (Dec. 30, 1991) (analysis showing that, under certain circumstances, neither shareholders nor creditors have appropriate incentives to act on behalf of an insolvent company).

companies are not in chapter 11, it is possible to argue that through contract provisions defining default, the creditors can protect themselves and society from wasteful investments intended to serve only shareholder interests. Such contract provisions enable creditors to resort to collection remedies that give them control over corporate assets, preventing managers from using the assets to facilitate risky investments. In chapter 11, exercise of those contractual rights is inhibited by the automatic stay, making it unacceptable to allow management to continue to exercise their discretion solely in the interest of shareholders.³²⁰

Although agreeing for these reasons that management should not serve just the interests of shareholders in chapter 11, several commentators have argued that shareholders should nonetheless be allowed to elect directors during reorganization. This view is partly based on statutory interpretation.³²¹ From a policy perspective,

³²⁰ Skeel makes this argument in defense of his proposition that the right to elect directors of insolvent corporations in bankruptcy should be routinely transferred to creditors. See Skeel, *supra* note 7, at 482-85.

³²¹ These commentators find a shareholder right to elect directors implicit in the provisions and structure of the Bankruptcy Code. See Budnitz, *supra* note 94, at 1266-67; Chou, *supra* note 94, at 576; Gerber, *supra* note 94, at 341-55.

From the absence of an express provision barring shareholders from electing directors, they infer that Congress must have intended that the pre-filing practice continue after filing. See Budnitz, *supra* note 94, at 1240 (arguing that the prohibition of distribution on non-voting stock as part of a reorganization plan shows that Congress was concerned about shareholder rights to elect directors and concluding that if Congress intended that shareholders' usual rights to elect directors be suspended during chapter 11, they would have said so directly). They point out that Congress substituted specific remedies available only in bankruptcy for the rights creditors lose by imposition of the automatic stay. For example, creditors can ask the court to replace management with a trustee, *see supra* notes 112-22 and accompanying text, they can object in court to various actions by management which require court approval, *see supra* notes 134-38 and accompanying text, and they can ask the court to remove exclusivity and propose their own plan of reorganization, *see* 11 U.S.C. § 1121 (1988). These commentators argue that if Congress had intended creditors to have the additional right to block shareholder election of directors, surely it would have so provided.

Chou also cites language in the Senate Committee Report that accompanied the bill that eventually became the Code as indicating that "Congress clearly intended that shareholders not be left to the mercy of the debtor and its creditors." Chou, *supra* note 94, at 577 (citing S. REP. NO. 989, 95th Cong., 2d Sess. 9-10 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5796). While there is language to that effect in the Senate Report, nothing in the Committee discussion addresses specifically the question of shareholder elections. Further, the Senate version of the bill addressed by the Committee Report was more protective of shareholder interests than is the Code as adopted.

As a matter of statutory interpretation, we think that neither these authorities nor the contrary view expressed by the Second Circuit in *In re Johns-Manville Corp.*,

their main concern is that if shareholders are not permitted to elect new directors during chapter 11, they will be without significant bargaining leverage in the negotiations about the business and reorganization plans.³²²

While there is no doubt that shareholder bargaining leverage and ability to discipline management will be reduced if shareholder elections are enjoined, we believe the greater danger is that shareholders will use the threat of elections to induce management to adopt corporate policies that are wasteful and inconsistent with a public policy favoring resource allocation efficiency. Creditors would continue to dominate some managements through the leverages we have described. But the strength of those leverages varies from case to case. In other cases, aggressive shareholders could install management that would pay little concern to the interests of creditors.

We believe it is "clear abuse" for shareholders to use the election process to influence management to hold out for better treatment for shareholders in the business and reorganization plans of an insolvent company and that this practice can³²³ and should be enjoined.³²⁴ The more difficult issue is whether there are *any* circumstances in which the shareholders of an insolvent, reorganizing company should be permitted to elect directors. Certainly an incompetent or corrupt management should be removed. The issue is whether election should be an alternative to

801 F.2d 60, 65 n.6 (2d Cir. 1986), are clearly wrong.

³²² As Gerber stated:

[S]tockholders who are allowed to form committees, but who are denied the right to vote for directors, are no better off than stockholders who are allowed to vote, but who are deprived of a vehicle for concerted action. In the first instance stockholders are given a place to stand but no lever, in the second they are given a lever but no place to stand.

Gerber, *supra* note 94, at 352.

³²³ It is virtually universally accepted that courts *may* enjoin shareholder elections when they would constitute a "clear abuse." See *supra* notes 94-108 and accompanying text.

³²⁴ The Second Circuit seems to agree. See *In re Johns-Manville Corp.*, 801 F.2d at 65 n.6 ("We note that if Manville were determined to be insolvent, so that the shareholders lacked equity in the corporation, denial of the right to call a meeting would likely be proper, because the shareholders would no longer be real parties in interest."). But see *Saxon Indus. v. NKF Partners*, 488 A.2d 1298, 1300 (Del. 1984) ("[A]bsent other compelling legal or equitable factors, insolvency alone, irrespective of degree, does not divest the stockholders of a Delaware corporation of their right to exercise the powers of corporate democracy.").

the more direct motion for the appointment of a trustee.³²⁵ If the removal is by election, the ousted manager's successor is chosen by the shareholders, whereas a trustee would be appointed by the U.S. Trustee.³²⁶ In the normal case, removal by appointment of a trustee would be more expeditious and cheaper, but that does not necessarily mean that the possibility of removal by more cumbersome shareholder election process should be foreclosed.³²⁷

Our reasons for opposing shareholder elections apply most strongly to the insolvent corporation. But if the equity of a solvent company is so thin that the risks of loss created by managerial decisions are borne largely by creditors rather than shareholders, shareholders will not have the correct incentives to control investment policy. The analysis is the same as for insolvent companies. Consequently, in this circumstance as well, shareholders should not have the unfettered right to call meetings of shareholders for the purpose of electing managers who will prefer their interests over those of creditors.

Substantially solvent companies occasionally file under chapter 11. The shareholders of those companies for the most part bear both the risk of loss and the prospect of gain. In the terminology used in the next section, they are the "residual" owners. For the reasons stated in that section it is appropriate for them to elect directors during reorganization and command the loyalty of management.

B. *Collapsed Residual Ownership*

From an economic perspective, an accepted approach for ensuring that a corporation acts in accordance with wealth maximization norms is to vest the power to govern the corporation in the "residual owners"—that is, those who stand to gain from profits and suffer from losses. Professors Baird and Jackson have suggested

³²⁵ See 11 U.S.C. § 1104(a) (1988).

³²⁶ See *id.* § 1104(c).

³²⁷ In enjoining a meeting of shareholders, the court in FSC noted that it would cost \$60,000 to conduct it. See *supra* notes 100-02 and accompanying text. Legislative history suggests that Congress permitted the management of a reorganizing company to remain in office largely out of concern for the possibility that management, fearful of losing their jobs and their leverage, might otherwise delay the filing of the chapter 11 case. See *supra* note 281 and accompanying text. Once management has been ousted by any mechanism, appointment of a successor by the U.S. Trustee rather than shareholders does no harm to this policy.

that vesting control in the residual owners is the solution to the problem of corporate governance in the reorganizing company:

The Bankruptcy Code pays too little attention to ensuring that the residual claimants are in control of the firm. . . . [T]he law of corporate reorganizations should focus on identifying the residual owner, limiting agency problems in representing the residual owner, and making sure that the residual owner has control over the negotiations that the firm must make while it is restructuring.³²⁸

We do not doubt that placing control of the reorganizing firm in the hands of parties who have both the risk of loss and the possibility of gain can be an effective way to promote wealth maximizing behavior. The primary problem—often unrecognized—is that there will commonly be more than one class of claims or interests that qualify simultaneously as the “residual owner” of an insolvent firm. The prescription that control should lie with the residual owners does not tell us how control should be apportioned among those classes.

To illustrate this point, assume that a firm has underwater classes of claims and interests. In the absence of bankruptcy, these claims and interests will continue to have market value. One reason is that any ensuing reorganization case would almost certainly culminate in a distribution that deviated from the absolute priority rule.³²⁹ But a quantitatively more important reason such claims and interests retain value is that so long as the firm remains in business there continues to be an “upside” potential in the value of

³²⁸ Baird & Jackson, *supra* note 7, at 765, 775. Baird and Jackson give the following rationale for vesting power in the residual owner:

The residual owner is given the power to bind the firm because the residual owner stands to have the right set of incentives. The dollar that is won or lost because of good or bad negotiating by definition is felt by the residual owner. . . . The residual owners should always be the ones who enjoy the benefits of making good decisions and incur the costs of making bad ones.

Id. at 761, 787-88. Though Baird and Jackson do not discuss specifically how they would implement residual owner control in the insolvent company, Skeel has drawn the logical conclusion. The creditors should be entitled to elect the board of directors. *See* Skeel, *supra* note 7, at 510-13. Frost proposes a somewhat different implementation scheme. He wants courts to give deference to the views of residual owners when approving management actions pursuant to 11 U.S.C. §§ 363-65. *See* Frost, *supra* note 10, at 136-37.

³²⁹ *See* LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 142.

the business. If the increase is large enough, a part of it will inure to the benefit of those claims and interests.³³⁰

At least in the absence of a default, Baird and Jackson accept that a firm might have the potential to increase in value and the potential may give value to claims and interests that are currently underwater.³³¹ Nevertheless, they assert that a single class of residual owners always exists. They reach this result by "collapsing" the future possibilities of different values to a single present value and using this latter value to identify the single residual owner.³³² Thereafter they assume that this residual owner, like a true residual owner, will have the appropriate incentives to maximize the value of the company.³³³

Yet for them to say that the future possibilities of different values have been collapsed to a single value by the debtor's default under the loan agreement does not make it so.³³⁴ After they determine which class is the residual owner and give them control of the company, changes in the actual value of the company will continue to occur. If the changes are sufficiently large, they may,

³³⁰ For a recent theoretical account of why the stock of a distressed firm retains value despite insolvency, see BEBCHUK & CHANG, *supra* note 8, at 4.

³³¹ See Baird & Jackson, *supra* note 7, at 761 ("[I]n the absence of a default, everyone's ownership interest has a value. There is always a possibility that the firm's assets will be worth more—and its liabilities less—than expected.")

³³² See *id.* at 761 ("The firm that is reorganizing is typically insolvent. In the case that we focus on . . . , if all future possibilities were collapsed to present values, the senior creditor would be entitled to the entire firm. In this sense, the senior creditor is the residual owner of the firm.")

³³³ See *id.* at 787-88; see also, e.g., Frost, *supra* note 10 at 112, 130-31, 136, 140 (making similar assumptions).

³³⁴ While they do not address the question directly, we doubt that Baird and Jackson actually would assert that the stock of an insolvent company has no value after the company defaults. Rather, they would treat the stock as having no value because under their conception of the creditor's bargain, it *should* have no value.

Baird and Jackson developed their "collapsed residual ownership" concept to deal with a different problem than the corporate governance problem that is the focus of this Article. Specifically, they proposed that the residual creditor interests (as determined by the collapsed residual owner concept) be permitted to agree to distribute some value to the most junior interests while freezing out interests that have a higher priority though still underwater. See Baird & Jackson, *supra* note 7, at 760, 783-85. Currently, the intermediate interests could bar confirmation of the plan under the absolute priority rule. So long as formulation of the reorganization plan takes place at a time so close to confirmation that determination of the "collapsed residual owner" is a good surrogate for entitlements at confirmation under the absolute priority rule, there is merit in their proposal. In practice, however, reorganization plan negotiations commonly occur well before confirmation, when junior interests still have real potential to benefit from an upside gain.

for example, render an insolvent company solvent or at least arguably so. Even though these changes occur after default and after the filing of the reorganization case, so long as they occur before the underwater claims and interests can be extinguished at confirmation, these increases in value will accrue at least in part to the benefit of the holders of those claims and interests.³³⁵ Thus underwater claims and interests may continue to bear the consequences of investment decisions. They, along with the collapsed residual owner, remain "residual owners."

Under Baird and Jackson's concept, creditors would be the "collapsed residual owners" of any insolvent firm. Yet these collapsed residual owners, while bearing most of the risk of decreases in value, stand to reap only a small part of increases in value. They would not be as interested as they should be, from a wealth-maximization perspective, in a business plan that maximized the value of the company through high risks fully warranted by correspondingly high returns.³³⁶

It is important to realize that this problem of inappropriate incentives is likely to exist even though the firm is substantially

³³⁵ Under current law, the courts value the company as of the date of confirmation of the plan for the purpose of determining whether the proposed plan complies with the absolute priority rule. See 11 U.S.C. § 1129(b)(2)(C) (1988) (a plan can be crammed down against equity holders only if the plan provides that each retain "property of a value, as of the effective date of the plan, equal to . . . the value of [the equity holder's] interest"); see also *In re Guilford Telecasters, Inc.*, 128 B.R. 622, 625-27 (Bankr. M.D. N.C. 1991); *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 304-07 (Bankr. W.D. Pa. 1990) (experts value company as of a date close to confirmation); *In re Pullman Constr. Indus.*, 107 B.R. 909, 950-51 (Bankr. N.D. Ill. 1989).

Confirmation of the plan of reorganization implicitly fixes a value for the company and thereby collapses the possible array of values that a particular interest in the company might have. As a practical matter, the value of a company is often fixed before confirmation when the parties agree on the terms of the plan to be confirmed. In one of the cases studied, Storage Technology, the value of the company increased substantially between the time the parties agreed to the terms of a plan and the time the plan was considered by the court for confirmation. The parties stuck to their bargain and the court confirmed the plan. As a result, some classes of creditors received stock in the emerging company that had a value substantially in excess of the full amount of their claims.

³³⁶ While Skeel also advocates the collapsed residual ownership theory for resolving corporate governance problems, he acknowledges the possibility that a corporation so governed will be too risk averse from a wealth maximization perspective. But he dismisses the possibility as empirically insignificant. See Skeel, *supra* note 7, at 501 n.149. We do not think it is insignificant. In our empirical observations, we noted that even under current corporate governance rules firms in chapter 11 rarely undertook new business initiatives. See *supra* notes 251-56 and accompanying text.

insolvent and certain to remain so. In the bankruptcy reorganizations of large publicly held firms, there are likely to be several creditor classes whose claims carry different priorities. Under the collapsed residual ownership theory, one of the more senior creditor classes of a substantially insolvent firm would be considered the residual owner. But given the number of layers of claims in large, publicly held companies,³³⁷ there is likely to be a creditor class immediately junior to the collapsed residual ownership class that stands to benefit from any significant increase in the collapsed value of the firm.

To provide the collapsed residual owners with the appropriate incentives to manage the reorganizing company would require radical change in the reorganization process. One such change might be to require that, soon after filing and before a business or reorganization plan is adopted or considered, the court actually collapse the possibilities of future changes. The court could do this by valuing the company and fixing the entitlements of the various classes.³³⁸ Because those entitlements would be enforced

³³⁷ To give some concrete indication of the number of different levels of priority in a complex bankruptcy case, we counted the number of levels, making the assumption that no substantive consolidation would occur. The assumption of no substantive consolidation is significant, because in a multi-tiered company the creditors of different corporate entities occupy potentially different priority positions. We excluded from the count all secured creditors, all creditors with bankruptcy priorities, and all securities fraud claimants. That is, we counted only layers of nonpriority unsecured creditors and shareholders. In 31 of 43 cases, there were four or more levels of priority. The average number of levels exceeded five.

Cases with less than four levels of priority were: Air Florida, AM International, Dreco, EPIC, Johns-Manville,* Lionel, McLouth, NuCorp,* Phoenix Steel, Salant, Sambo's Restaurants, and Smith International.*

Cases with four levels of priority were: Cook-United, MGF, Pizza Time Theatre, Revere, Saxon, Seatrain Lines, Technical Equities, Towner, and Wilson Foods.

Cases with five levels of priority were: Anglo Energy, Crystal Oil, Energetics, Itel, KDT, Marion, Tacoma Boatbuilding, and Towle.

Cases with six levels of priority were: Baldwin-United, Braniff, HRT, and Storage Technology.*

Cases with seven levels of priority were: Continental Airlines, FSC, Oxoco, and White Motor.*

Cases with more than seven levels of priority were: Amarex, Charter, Combustion Equipment, Evans Products, Penn-Dixie, and Wickes.

An * indicates that we did not have enough information to ascertain the precise number of potential priority classes, usually because of inadequate information about claims against a subsidiary. In these cases, we have given the minimum number of classes; the actual number is probably higher.

³³⁸ Applying the collapsed residual ownership theory in this manner is arguably unfair to underwater creditors and equity holders, who may have relied on the current practice whereby they benefit if companies with financial difficulty

regardless of changes in the value of the company during the case, all future increases in value would accrue to the most junior remaining class, which would have an incentive to manage the company efficiently. But valuation of the company at filing would cause so much expense and delay that it is entirely impractical.³³⁹ Furthermore, while the values were being litigated, management would remain without guidance as to whom they should be loyal.

C. *The Principle of Prudent Investment*

The Bankruptcy Code provides that a debtor-in-possession "shall perform all the . . . duties . . . of a trustee."³⁴⁰ This language suggests looking to the law of trusts for guidance to the corporate governance dilemma.³⁴¹ Trust law does deal with analogous situations, where the interests of successive beneficiaries conflict.

successfully reorganize. If their interests are cut off at the time of filing, their expectation of sharing in future increases in value will be denied. This fairness problem would only be transitional, however. Once it was established that the collapsed residual owners at the time of filing owned the most junior interest in the firm, new lenders and investors would adjust their expectations accordingly.

³³⁹ A major objective of the 1978 reforms was to relieve the court of the necessity to value the company in every case. See H.R. REP. NO. 595, *supra* note 281, at 224; REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES PART I, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 256-58 (1973). The 1978 legislation accomplished that by permitting the court to confirm consensual plans without regard to values. The proposal considered here would revive the necessity for valuation by requiring that the value determination be made before the parties have had time to resolve their difference by agreement.

In previous articles, we have proposed that early in the proceeding there be a "preemptive cram down," as we call it, against classes that are so far underwater that there is no reasonable probability they will be entitled, under the absolute priority rule, to receive a distribution at the time of confirmation. See LoPucki & Whitford, *Preemptive Cram Down*, *supra* note 16; LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 16, at 186-89. Our purpose in limiting preemptive cram down to classes that have no reasonable probability of entitlement to share under the plan was to avoid the need for a precise valuation of the company early in the proceeding. In most cases, not all classes junior to the collapsed residual owner would be subject to a preemptive cram down under that standard. Furthermore, we proposed that if the improbable occurs and the value of the firm so increases that the previously terminated interest would have received a distribution if there had been no preemptive cram down, then that interest should be reinstated to receive its appropriate distribution. Hence, our proposal was quite different and much more modest than the Baird and Jackson proposal.

³⁴⁰ 11 U.S.C. § 1107(a) (1988).

³⁴¹ Some courts take the analogy almost literally. See, e.g., *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797, 802 (9th Cir. 1987) ("The debtor-in-possession is not free to deal with [property of the estate] as it chooses, but rather holds it in trust for the benefit of creditors, just as would a trustee.").

Consider the common trust in which one beneficiary has the right to the income and another has the right to the principal after some period of time. Just as management of the reorganizing company can shift value from creditors to shareholders through excessive risk-taking, so can the trustee shift value from the residual beneficiary to the income beneficiary by investing in high risk, high income assets.

The *Restatement (Second) of Trusts* provides that “[w]hen there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them.”³⁴² While this statement is vague, it is interpreted as requiring the trustee to maintain an investment policy that “balances” the interests of the competing beneficiaries. Investment policies focused solely on generating high income (e.g., high yield but risky junk bonds) and investment policies targeted solely on preservation or growth of the principal (e.g., unproductive land with little rental value but whose value may increase in the future) would be equally inappropriate.³⁴³

Another rule from the law of trusts that bears on the conflict between successive beneficiaries is the “prudent” investor rule. That rule requires that the trustee “make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived.”³⁴⁴ Though vague in its specification of what is considered “prudent,”³⁴⁵ the rule appears to contemplate a narrow range of risk that would be deemed appropriate for trust investments, one that avoids the extremes of being either too conservative or too risky. Thus, the prudent investor rule commands a result similar to the interest-balancing rule discussed in the preceding paragraph.

These principles from trust law are somewhat analogous to the investment policies we observed in many of the cases studied.³⁴⁶

³⁴² RESTATEMENT (SECOND) OF TRUSTS § 183 (1959).

³⁴³ See WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 232 (4th ed. 1988) (“[T]he trustee is under a duty so to administer the trust as to preserve a fair balance between [successive beneficiaries].”); Case, *supra* note 146, at 373, 398-403 (“In conflicts between remainderman and income beneficiaries, the personal trustee is put in a position of balancing the flow of income versus the preservation of the principal.”).

³⁴⁴ RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

³⁴⁵ In the early 1900s, state legislatures in some states enacted “legal lists” of the permissible investments for trustees. See Leslie J. Bobo, Comment, *Nontraditional Investments of Fiduciaries: Re-Examining the Prudent Investor Rule*, 33 EMORY L.J. 1067, 1073 (1984).

³⁴⁶ We do not mean to suggest that the level of risk-taking considered appropriate

That is, there seemed to be a general understanding that management should steer a middle road with regard to risk-taking. At least in the early stages of the proceedings, managements generally did what was necessary to continue the existing businesses of the companies. And so long as a company remained in bankruptcy, management did not make the kind of risky new investments that might, if successful, substantially increase the company's value.³⁴⁷ The balance between senior and junior interests was drawn with an emphasis on preservation of the existing business; that is what was considered "prudent" in this context.³⁴⁸

While prudent investment seems to be the principle governing investment policy in many reorganizations, there is reason to think it is not the best one. This policy means that during the often extensive period of a chapter 11 proceeding³⁴⁹ management is not investing company resources in a manner that maximizes their value. For example, the prudent investment principle may prevent the company from making an acquisition necessary to maximize the company's own value, or may prevent a liquidation that would in fact maximize value. The result may be to lock the company into an inefficient "holding pattern" because any change in investment policy would have distributional consequences adverse to particular classes of creditors and shareholders.

for the reorganizing company is no higher than the level considered appropriate for the investment of trust funds. The former levels are generally much higher than the latter. The similarity lies in the fact that management of the reorganizing company, like the trust administrator, is expected to confine its investment policies to courses that do not involve particularly high or particularly low risks.

³⁴⁷ See *supra* notes 252-56 and accompanying text.

³⁴⁸ Another analogy which may be helpful is the yellow flag used in automobile racing to indicate that drivers should not attempt to better their position relative to other drivers until some adverse track condition has been remedied. The bankruptcy reorganization equivalent of an adverse track condition is the separation of risk of loss from possibility of gain. When an adverse condition develops, the level of risk at which the company's assets have been invested has established the relative values of the debt and equity interests in the company. In the analogy, those relative values are the equivalent to the relative positions of the cars. While the risk remains separated from the gain, that is, until the confirmation of a plan, management should not favor either creditors or shareholders by reinvesting the assets at either a higher or lower level of risk.

³⁴⁹ In our study, the average duration for cases not filed in New York City (30 cases) was 2.1 years. For cases in New York City (13 cases), the average duration was 2.8 years. See LoPucki & Whitford, *Venue Choice*, *supra* note 16, at 31 n.68.

D. Representation

A leading practitioner has offered an innovative solution to the problem of corporate governance during reorganization. He proposes that management be free to adopt (1) a pro-equity stance, (2) a pro-creditor stance, or (3) a neutral stance (which he calls stakeholder-mediator).³⁵⁰ He would require that management publicly announce the orientation they have adopted early in the case. Each constituency not represented by management then would be entitled to other representation. Ordinarily, the alternative would be representation by a committee whose lawyers' fees would be paid by the estate.³⁵¹

We refer to this proposed solution to the corporate governance problem as "representation." Its most attractive aspect is that it enables management to know who they represent. Presumably, management's fiduciary duties would run only to the class they chose to represent. The representation approach would also ease the problem of deciding when shareholders should be permitted to replace management through voting. If management chose a pro-shareholder stance, corporate democracy would continue. If management chose another stance, they would no longer be the representatives of shareholders and shareholders would no longer be entitled to remove them by voting.

The representation proposal has serious shortcomings. By resting on the assumption that the appropriate outcome will result when all constituencies are represented, the proposal begs the question. It relieves management of the obligation to make tough decisions. But it does not determine whose interests corporate decisionmaking should serve. Instead, it leaves the tough decisions for the court. For example, when parties object to proposals that constitute part of management's business plan, on what basis should the court make its decision? Because representation does not seek to assure that management's service of their chosen master will also maximize the value of the company, the deference courts have

³⁵⁰ See Case, *supra* note 146, at 382-85. Case is not explicit as to the kind of investment policy a stakeholder-mediator management should adopt. He may have intended either that they seek to maximize the estate, *see supra* text accompanying note 238, or that they pursue the prudent investment policies discussed in the preceding section. On issues that have strictly a distributional consequence, he would apparently require that stakeholder-mediator managements not take sides. See Case, *supra* note 146, at 383.

³⁵¹ See Case, *supra* note 146, at 384.

customarily given to management's business judgment would no longer be appropriate. Representation would require that the courts become more deeply involved in the company's decision-making process. Yet they would have to do so without guidance as to whose interests to serve.

We have a number of other concerns with the representation proposal. It requires a considerable strengthening of the committee structure in chapter 11, which might significantly increase the cost of reorganization. Though unsecured creditors' committees are generally well-staffed, they may be no match for a management sworn to represent shareholder interests exclusively. Equity committees are rarely staffed sufficiently to meet this burden if management were to adopt a pro-creditor stance.³⁵² Moreover, the representation proposal does not indicate what management should do in the common situation where there are conflicts of interest among different classes of creditors. Should management announce its loyalty to one class of creditors (e.g., secured creditors), leaving others to fend for themselves through representation by committee? If so, it would put an even greater emphasis on strengthening the committee process.³⁵³

E. *Maximize the Estate*

One possible solution to the problem of corporate governance would be to postulate that management's objective should be to maximize the value of the bankrupt company,³⁵⁴ without regard

³⁵² That equity committees are not as well-staffed as creditors' committees is common knowledge among lawyers who participate in the reorganizations of large, publicly held companies. However, in our empirical study we did not systematically collect data on the overall staffing of committees or on their professional fees. For a comparison of the frequency with which creditors' and equity committees retained investment bankers, see Table IX, *supra* note 308.

³⁵³ During the period covered by our study, the courts sometimes permitted subordinated debt classes to form their own committee. But in most instances, the unsecured creditors' committee represented subordinated debt classes along with the senior classes. The purpose was to save on professional fees. Establishment of a separate committee duplicates expenditures for attorneys and perhaps other professionals as well. In a system in which management is permitted to announce its allegiance to only one class of creditors, it is doubtful that the unsecured creditors' committees could adequately represent the interests of subordinated debt classes.

³⁵⁴ The idea that management has an obligation to maximize the value of the firm is hardly new to bankruptcy law. It is well-established that this is the duty of a chapter 7 bankruptcy trustee. See, e.g., *In re McKeever*, 132 B.R. 996, 1004 (Bankr. N.D. Ill. 1991) ("In a Chapter 7 case, . . . the primary duty of the trustee is to maximize the estate available for distribution to creditors."). Such language appears

to how this might affect the relative distributions to creditors and shareholders. Management would decide between alternative courses of action by deciding which yielded expected returns with the higher market value. If the question were whether to close the business and sell the assets or borrow against the assets and reopen, management should resolve it by comparing the anticipated return from liquidation with a weighted average of its estimates of the different possible returns from reopening, discounted for risk.³⁵⁵ Similarly, management's only legitimate interest in the post-confirmation financial structure of the firm would be to assure that it did not render the firm less valuable than some other financial structure.³⁵⁶ The purely distributional issues dealt with in the reorganization plan would be most appropriately negotiated among the creditors and shareholders.³⁵⁷ Absent agreement, management would propose a distribution only to enable the case to go forward. The distribution they proposed would normally have to be in accord with the absolute priority rule.³⁵⁸

The maximization principle has a number of shortcomings. The possibility that it will operate to the exclusion of other societal values was noted earlier.³⁵⁹ Even if maximization were a com-

in chapter 11 cases, although much less often. *See, e.g.,* *Wabash Valley Power Ass'n v. Rural Electrification Admin.*, 903 F.2d 445, 451 (7th Cir. 1990) ("A debtor [in possession] in bankruptcy is supposed to maximize the value of the estate . . .").

³⁵⁵ To illustrate, assume that management had the option to sell the assets of the estate for \$100 million or to borrow \$100 million against those assets and reopen the business. There is a 50% chance that the reopening will be a success and the business will be worth an amount that has a present value of \$240 million; there is a 50% chance that the business will fail and be worth nothing. Assume also that the market would discount these expectancies from the reopening option by an additional 10% because of their high-risk nature, but would not further discount the expectancy from liquidation because it is certain. *See supra* note 289. Management would be expected to maximize the estate by reopening the business, because the value of reopening is higher. It is \$120 million (50% of \$240 million), less a \$12 million risk discount, or \$108 million, as compared to an expected return of \$100 million from liquidation.

³⁵⁶ By "financial structure" we mean the amounts and types of securities that the firm will issue. A reorganizing company might issue only stock (often preferred by the former shareholders) or it might issue various combinations of stock and debt (often preferred by the former creditors).

³⁵⁷ This would put management in a similar position to a management that had chosen a stakeholder-mediator role under the representation proposal. *See supra* note 350 and accompanying text.

³⁵⁸ Absent acceptance by adversely affected classes, only such a plan could be crammed down over objection. *See* 11 U.S.C. § 1129(b)(2) (1988). Thus in many cases, only such a plan could complete the reorganization without the agreement of the disputing classes.

³⁵⁹ *See supra* note 264 and accompanying text.

pletely worthy objective, it would often be of limited use as a standard against which to measure management's performance and thereby control the exercise of their discretion. For example, if management must choose between immediate liquidation or continuation of the business, placing a value on either option may involve a good deal of guesswork.³⁶⁰ A management secretly allied with one interest or another could bias valuation judgments in their favor with little fear that their bias could be proven.

The most obvious difficulty with the maximization principle, however, is that it requires management to take whatever level of risk will maximize the value of the estate. When management chooses between investments with different levels of risk, its choice has distributional effects.³⁶¹ The choices will not only alter the ultimate distributions made at confirmation—they will have an immediate differential effect on the current trading values of claims and interests having different priorities.³⁶² The magnitude of those distributional effects can far exceed the increase in the value of the estate achieved by maximizing. As a result, a management faithful to maximization could be obliged to significantly alter the value of the prospective distributions to the various classes in order to achieve what even management perceive to be a tiny increase in the total expectancy value of the firm.

To illustrate, assume that reopening a chain of restaurants would require an all-or-nothing risk of the company's entire \$100 million value, that exactly that amount is owing to creditors,³⁶³

³⁶⁰ This should be evident with respect to the value of continuing in business. This is the kind of value estimation that was once described by a leading practitioner-scholar as a "guess compounded by an estimate." Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 313 n.62 (1982) (citing H.R. REP. NO. 595, *supra* note 281, at 222, *reprinted in* 1978 U.S.C.C.A.N. 5787, 6181). To a lesser degree, it is true with respect to the prospective value of the company in liquidation. Only by going through the extensive and sometimes risky process of soliciting potential buyers and negotiating a sale can management accurately determine the price for which the company can be sold. Among the risks in soliciting buyers (sometimes referred to as "putting the company in play") is the possibility of damaging ongoing relations with labor, customers, and suppliers, thereby perhaps reducing the company's value as a going concern. Rather than take those risks, in making decisions about whether to liquidate, management may prefer to guess at the price a liquidating sale would yield.

³⁶¹ Warren has made a similar point in another context. She argued that a policy of paying interest to secured creditors, which may be justified on wealth maximization principles, is not distributionally neutral. *See* Warren, *supra* note 264, at 800-03.

³⁶² There is now a developed market for claims and interests of large companies in chapter 11. *See generally* Fortgang & Mayer, *supra* note 109, at 2-3 (detailing recent developments in the trading of such claims).

³⁶³ That is, the company borders on solvency. Our illustration borrows on the

and that management's assessment of the expectancies from reopening or liquidating the restaurants is as follows:

TABLE X
VALUE OF EXPECTANCIES FOR FIRM

	Level of risk	Total return	Value of expectancies before risk discount	Market value ³⁶⁴
Liquidate	0%	\$100 million	\$100 million	\$100 million
Reopen	50%	\$240 million or \$0	\$120 million ³⁶⁵	\$105 million

The maximization principle would require that management pursue this \$5 million increase in the market value of the firm instead of liquidating. Yet, as Table XI shows, the decision to reopen would diminish the value of the creditors' expectancy to less than half of what it would have been in liquidation:

TABLE XI
VALUE OF EXPECTANCIES FOR CREDITORS

	Level of risk	Creditors' return	Value of creditors' expectancy before risk discount	Market value of creditors' expectancy
Liquidate	0%	\$100 million	\$100 million	\$100 million
Reopen	50%	\$100 million or \$0	\$50 million	\$43.75 million ³⁶⁶

Management's decision to reopen would have the opposite effect on the value of the shareholders' expectancy. In relation to what each

facts of one of the cases in our study, Sambo's Restaurants. In that case, the investment in reopening and redecorating restaurants was approved by creditors because the company was deeply insolvent and the benefit of any increase in value would have gone to the creditors. The reopenings were a spectacular failure, however, and as a consequence of the decision to reopen, creditors' losses mounted significantly.

³⁶⁴ In this and subsequent tables, we have assumed no risk discount for the expectancy arising from the liquidation option and a risk discount of 12.5% for the expectancies arising from the reopening options. See *supra* note 355. These assumptions are arbitrary and are not based on actual market discount rates or estimates thereof.

³⁶⁵ This number is simply a weighted average of the possible results indicated in the previous column. Since each outcome has a 50% probability, the expectancy is the average of the two.

³⁶⁶ We have assumed a risk discount rate of 12.5%. See *supra* note 364.

would receive in liquidation, the shareholders would gain even more (\$61.25 million) than the creditors' would lose (\$56.25 million).

TABLE XII
VALUE OF EXPECTANCIES FOR SHAREHOLDERS

	Level of risk	Shareholders' return	Value of shareholders' expectancy before risk discount	Market value of shareholders' expectancy
Liquidate	0%	\$0	\$0	\$0
Reopen	50%	\$140 million ³⁶⁷ or \$0	\$70 million	\$61.25 million

In the example we have presented, the distributional effects are particularly large due to our extreme assumptions. Management's choice is between a risk free liquidation or an all-or-nothing gamble on reopening. Because the company is assumed to border on solvency, the separation of the risk of loss from the possibility of gain is complete. Even so, the example may not be far-fetched.³⁶⁸ In cases where a prospective purchaser has an offer on the table, liquidation usually is a low-risk proposition. In contrast, continuation of a financially distressed business usually involves much more risk. Failure of a barely solvent company is unlikely to render its remaining assets worthless, but it could easily wipe out the entire entitlement of a junior class under the absolute priority rule. Thus,

³⁶⁷ This figure assumes that the reopening was successful and that the restaurant chain became worth \$240 million. If a reorganization plan was then confirmed and securities having this value were distributed, the first \$100 million in securities would be distributed to creditors under the absolute priority rule, leaving securities worth \$140 million for shareholders.

³⁶⁸ Several of the companies studied bordered on solvency during the reorganization case and a few engaged in investment policies that risked virtually the entire company. Continental Airlines serves as the best example of this phenomenon in our study. See *supra* note 3 and accompanying text.

Warren was the first to direct our attention to what may be the purest real life manifestation of the problem we address. In *In re Central Ice Cream Co.*, 59 B.R. 476 (Bankr. N.D. Ill.), *aff'd*, 62 B.R. 357 (N.D. Ill. 1986), the debtor's sole asset was a verdict against McDonald's for \$52 million. Before McDonald's motion for judgment notwithstanding the verdict was decided, McDonald's offered \$15.5 million in settlement. That amount was sufficient to pay creditors in full, but left the estate with only \$1 million to \$3 million, the bulk of which probably would have been applied to expenses of administration. The bankruptcy court approved the settlement over the objection of shareholders.

continuation of the business can easily be an all-or-nothing risk for a particular class.³⁶⁹

The existence of potentially huge distributional effects from the investment policies pursued by management casts doubt on management's ability to remain unbiased while determining what course of action will maximize the estate. We have already demonstrated that a management overseeing a reorganization operates in an environment rife with conflict³⁷⁰ and responds to that environment.³⁷¹ When the distributional effects of a decision will be large, creditors and shareholders can be expected to attempt to influence the process. The possibility that their leverages will balance one another, thereby leaving management free to maximize, is wishful thinking.³⁷²

³⁶⁹ Of course, the distributional effects of a decision to maximize can run either in favor of senior claims or against them. This can be illustrated by changing the facts of the hypothetical to make liquidation, rather than reopening, the maximizing solution. Assume, for example, that the total market value of the liquidation would be \$110 million, while the total market value of reopening would still be \$105 million.

This changed assumption would not change the value of the creditors' expectancies from either reopening or liquidating. Whether the company were liquidated or reopened, creditors could recover no more than the \$100 million owed to them, while they would still have a 50% chance of losing their money in reopening and no chance of losing it in liquidation.

For shareholders, the value of the reopening option would remain the same; they would continue to have a 50% chance of recovering \$140 million on reopening. But the value of the liquidation option would increase to \$10 million, since if liquidation yielded \$110 million, creditors would be entitled to \$100 million and shareholders would be entitled to the remainder.

Because a maximizing management would choose to liquidate under these new assumptions, the shareholders' expected recovery would fall from \$61.25 million in the previous example to \$10 million, and the creditors' expected recovery would increase by an amount even greater than the reduction to shareholders. The increased benefit to the firm from liquidating rather than reopening would be only \$5 million, but this change in the business plan would shift more than \$50 million in expectancies from shareholders to creditors. Again, the distributional impact of the decision to maximize greatly exceeds the total benefit to the estate.

³⁷⁰ See *supra* Part II.

³⁷¹ See *supra* Part III.

³⁷² A rule requiring managers to maximize the chapter 11 estate could compel managers to undertake actions that could not or would not be undertaken outside of bankruptcy. Outside bankruptcy, the separation of risk of loss from the prospect of gain is likely to influence management behavior, and may prevent a management from adopting a maximizing course of action because of its likely distributional effects. Baird and Jackson have frequently argued that it is improper to use bankruptcy to alter pre-bankruptcy distributional entitlements because it provides incentives to "forum shop"; that is, to choose between the distributional effects of the bankruptcy and nonbankruptcy regimes. See, e.g., JACKSON, *supra* note 272, at 20-67; Baird, *supra* note 264, at 824-28.

If managements were able to overcome these influences and maximize the estates, the terms on which general unsecured credit is advanced to corporations may be less favorable than today, as creditors take account of the possibility of increased losses from bold investments during a subsequent reorganization.³⁷³ If this were to happen, the cost of raising capital through equity issues should decrease, as purchasers of equity anticipate benefits from risky undertakings in bankruptcy. If maximization of firm value in fact reduces deadweight losses, the net tendency should be to reduce the cost of capital.³⁷⁴

We live in a second best world in which the cost of capital may currently be either higher or lower than what is optimal. If it is lower than optimal, then further reduction would not be desirable.³⁷⁵ Nevertheless, until concrete evidence to the contrary is

We do not criticize the proposed maximization rule on this basis because we are unconvinced that forum shopping, as Baird and Jackson define the term, is a bad thing. If chapter 11 can resolve the financial difficulties of a reorganizing company in a way that yields more societal wealth than resolutions that would be reached outside bankruptcy, then the choice to file bankruptcy seems to us a good thing, and encouragement of it is no vice. For an analogous argument in a different context, see LoPucki & Whitford, *Venue Choice*, *supra* note 16, at 40-41.

³⁷³ The principle of prudent investment includes a tendency for management to resist quick liquidation of existing assets. This practice tends to harm creditors and would be lessened under an enforceable rule that required management to maximize within chapter 11. It is possible, therefore, that creditors as a group would be better off under a maximization rule than under a prudent investment practice. If so, the adverse effects on the terms of credit that are discussed in the text would presumably not occur.

³⁷⁴ An additional problem would exist in applying the maximization principle to companies that incurred their chapter 11 debt before the principle was adopted. The creditors of those companies probably did not lend on the assumption that the principle would be applied. The principle of prudent investment provides a better description of the current practice. See *supra* notes 346-48 and accompanying text. Sophisticated parties probably would have assumed its continuance. With regard to loans already made, the sudden introduction of the principle of maximization would defeat the expectations of the parties and create an unfair result.

This is, however, merely a transitional problem. Once management's duty to maximize the estate in bankruptcy has been established, creditors presumably will take the principle into account when setting terms of credit. Of course, in a world of perfect markets and perfect foresight, it would be no problem at all. Because lenders would have perfect information, they would have anticipated both the introduction of the maximization principle and the time at which it would occur, and fixed the price of credit accordingly. See LoPucki, *Strange Visions*, *supra* note 269, at 98-106.

³⁷⁵ See generally R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956) (describing the General Theory of Second Best); Richard S. Markovits, *A Basic Structure for Microeconomic Policy Analysis in our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the*

produced, we suggest that attempting to maximize the value of chapter 11 estates offers the best possibility for minimizing deadweight losses.

F. *Our Normative Solutions*

The root of the problem of governing the reorganizing company lies in the separation of the possibility of future gain from the risk of future loss. Although we have stressed the situation of the insolvent company in our analysis, the same problem exists in the marginally solvent company. There too, creditors bear most of the risk of future loss and reap disproportionately little of the benefit from future gain. In both situations, management's undivided loyalty to the interests of either shareholders or some or all creditors will lead to decisions that are too risk prone or too risk averse, as measured by the wealth maximization ideals that normally are so weighty when formulating legal rules to govern large commercial transactions.

1. Shorten the Proceedings

One of the basic purposes of reorganization is to reunify the possibility of gain with the risk of loss. In the large, publicly held company, this is usually accomplished by confirmation of a plan of reorganization that converts enough of the company's debt to equity to render the company comfortably solvent.³⁷⁶ The new equity holders then have both the possibility of gain and the risk of loss. The sooner that occurs in reorganization cases, the smaller is the potential that distorted incentives will result in bad investment decisions. It follows that bankruptcy courts should expedite chapter

Study of Law and Economics, 1975 WIS. L. REV. 950, 967-76 (describing the Theory and using it as a tool for measuring a policy's effectiveness).

To illustrate the point made in the text, the cost of capital might be lower than optimal because consumers cannot deduct many of their interest expenditures on their federal income tax. Consequently, consumers may bid less for investor's dollars than businesses, even when the utility of additional investment to both is the same.

³⁷⁶ Roe has expressed concern that the dynamics of chapter 11 cause some publicly held corporations to emerge from bankruptcy with too much debt. See Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 536-47 (1983). If this happens, it is a serious concern, since it suggests that the same corporate governance imponderables that are the subject of this Article remain with the company even after confirmation. In a forthcoming article, we present some evidence that Roe's fears are being realized. See LoPucki & Whitford, *Patterns*, *supra* note 16.

11 proceedings as much as possible. There are many reasons to avoid unnecessary delay,³⁷⁷ but a principal one is that delay prolongs the time during which the risk of loss is separated from the possibility of gain.³⁷⁸

Earlier termination of management's exclusive right to file a plan may be one means for expediting chapter 11 cases. Whether earlier termination will expedite a particular case will depend on the circumstances. There is a danger that when exclusivity is terminated holders of relatively small interests in a company will prosecute their own plans and divert the attention of other parties from serious negotiations. But in some cases, management itself is the principal barrier to quick reorganization. Once exclusivity has been lifted, the pressure to strike a bargain may become overwhelming.³⁷⁹ When this situation exists, bankruptcy judges should consider quick termination of exclusivity.³⁸⁰

2. Risk Compensation Payments

The advantages of maximization as the governing principle for the reorganizing company were previously discussed. In that discussion, we noted unfortunate distributional effects that can create incentives for classes of claims or interests to oppose

³⁷⁷ See Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. (forthcoming June 1993) (listing increases in professional fees, wealth shifting from inconsistent rules regarding interest, and the poor performance of reorganizing companies as additional problems caused by delay).

³⁷⁸ We earlier questioned the practicality of a proposal to require a sale of all assets sufficiently early in the proceedings to avoid corporate governance problems. See *supra* notes 276-308 and accompanying text. We are reluctant to endorse a requirement that a sale of all the assets be a part of every reorganization proceeding, but where a sale of assets can be accomplished more quickly than reorganization and without seriously diminishing the value available for distribution in the reorganization case, it should be encouraged. Such a sale reunifies the prospect of gain with the risk of loss.

³⁷⁹ In the Texaco bankruptcy, the mere suggestion by the bankruptcy judge that he might terminate exclusivity is widely credited with bringing that case to a more rapid conclusion than otherwise would have been possible. See Harvey R. Miller, *Texaco Inc.—An Unexpected Debtor Making Appropriate Use of the Bankruptcy Code*, in 62D ANNUAL MEETING OF THE NATIONAL CONFERENCE OF BANKRUPTCY JUDGES 5, 13-15 (1988); Mnookin & Wilson, *supra* note 265, at 307-09.

³⁸⁰ One difficulty with this proposal is that some bankruptcy judges want to attract the filing of large chapter 11 cases to their districts. A reputation of terminating exclusivity can deter managers, who generally determine the venue of chapter 11 cases, from selecting that district. We recognize this problem and advocate stricter controls on the discretion of bankruptcy judges to extend exclusivity in LoPucki & Whitford, *Venue Choice*, *supra* note 16, at 48.

management's efforts to maximize the value of the company. In this section, we propose a scheme of mandatory risk compensation payments that would reduce those distributional effects and thereby reduce the pressures on management to pursue sub-optimal business plans.³⁸¹

Initially, we note that like so many difficult problems of commercial law, the problem of implementing a rule requiring wealth maximization exists only because of transaction costs. Professor Coase has demonstrated that absent transaction costs, parties who seek only their own economic benefit will agree to a maximizing application of resources no matter how the underlying rules distribute legal entitlements in the first instance.³⁸² To illustrate the application of the Coase Theorem in the current context, suppose there was an enforceable corporate governance rule that management was to remain loyal to the residual owner as defined by the collapsed residual ownership theory. Further suppose that the company was barely insolvent, making creditors the residual owners, but that the maximizing course was to reopen the restaurant. Absent transaction costs and the attendant collective action problems, the shareholders could be expected to offer a payment to the residual owners that would make it in the latter's interest to agree to the reopenings. This is because the shareholders have more to gain from acceptance of the corporate opportunity than creditors have to lose. On the facts of the restaurant reopening hypothetical discussed above,³⁸³ shareholders could offer creditors almost all the value of their expectancy if the decision were made to reopen (\$61.25 million in the hypothetical) and still be better off than they would be if the corporate opportunity were passed up.

The same possibility of cooperation exists if we assume that the law required management to follow the prudent investment principle and management decided to reopen the restaurants as the

³⁸¹ Jackson recognized the need for compensation of this general sort, though he did not think that a device for implementing it could be devised. See JACKSON, *supra* note 274, at 216 ("No . . . device, however, exists (or can be readily devised) to require shareholders to compensate unsecured creditors for the costs of delay."). Jackson's concern was limited to the possibility that shareholders would be successful in delaying a liquidation that was in the interests of the creditors. See *id.* He did not consider that creditors are often able to block new investments that would be in the interests of the firm as a whole.

³⁸² See R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 42-44 (1960).

³⁸³ See *supra* notes 363-67 and accompanying text.

only way to preserve the business. In the absence of transaction costs, if liquidation were the maximizing course and if the parties were free to agree to it, a deal would be made. Creditors would have more to gain from liquidation than shareholders would have to lose; creditors would be in a position to make shareholders an offer that would leave both groups better off in liquidation.³⁸⁴

These Coasian deals are sometimes made in reorganization cases. For example, it is not unusual for the representatives of shareholders to consent to a liquidating plan if the plan provides a sufficient payment to shareholders.³⁸⁵ If such deals were made sufficiently early in every reorganization case, the effect would be to implement the maximization principle. But from our observations of these forty-three cases, it appears that as a practical matter such deals are made only as part of a plan of reorganization that resolves the entire case³⁸⁶ and only after a delay that averages about two years.³⁸⁷

³⁸⁴ A hypothetical presenting this situation is discussed *supra* note 369. In that example, creditors would gain \$56.25 million from the decision to liquidate (\$100 million) rather than reopening (\$43.75 million). See *supra* Table XI accompanying note 366. Shareholders would lose \$51.25 million from the same decision, since they will be paid \$10 million from liquidation proceeds (assuming the total proceeds of liquidation were \$110 million) instead of the value of reopening (\$61.25 million). See *supra* Table XII accompanying note 367. Creditors could then offer to give shareholders \$51.25 million of the proceeds received by the creditors from the liquidation option. Creditors would still be better off in the amount of \$5 million, whereas shareholders would now be indifferent as to the two options.

³⁸⁵ In the Lionel case, shareholders fought vehemently against efforts by creditors and management to sell the company's most valuable asset, Dale Electronics. See *In re Lionel Corp.*, 722 F.2d 1063, 1066 (2d Cir. 1983). Their stated reason was that the proposed sale prices were inadequate. But when auction sale of Dale was made part of a plan that also provided a generous distribution to shareholders, the equity committee consented to the plan.

³⁸⁶ An agreement by which certain classes consent to a particular course of action by management, in return for a payment prior to confirmation, presumably would require court approval as a compromise or settlement. See FED. R. BANKR. P. 9019. The parties might find it difficult to obtain the approval. The court could conclude that there was no reason for the payment because management was already bound to follow whatever course was in the best interests of the estate.

The same agreement probably could be approved as part of a plan of reorganization. First, as part of the plan it will be mixed in with the settlement of other issues between or among the classes, and therefore will not receive direct scrutiny. Second, because the agreement has been accepted pursuant to the formalities of the plan process, the court will not feel as much obligation to question it. Third, confirmation of the plan marks the end of the reorganization case. The bargain the court is being asked to approve goes to management conduct after, not during, reorganization.

³⁸⁷ Once the parties had agreed on the terms of a consensual plan, it was generally only a few months before the company was able to emerge from bankruptcy. The

The risk compensation payments we propose are a surrogate for the payments that would be made pursuant to the Coasian deals described above. We think the law should explicitly require that reorganization management maximize the value of the estate. Classes whose distributional expectations are diminished by that investment policy should be entitled to a compensating payment from classes whose expectations are augmented. The baseline entitlements from which the distributional shift would be measured are the amounts the affected classes could expect to recover if management followed the prudent investment principle. We regard that principle as establishing generally what the parties would receive under current practice.³⁸⁸

No money would change hands at the time of the "payment." The court would simply order that an appropriate portion of the claims or interests of the class benefiting from the attempt to maximize have become the property of the class adversely affected by it. The effect would be to achieve the efficiency gains that flow from maximizing conduct by management while preserving the distributional effects of the prudent investment principle.

To understand how this compensation system would work, consider the example of a chain of restaurants with the financial structure shown on the right side of Figure III. Investors in the company occupy four levels of priority. The company owes secured creditors \$200 million secured by all of the company's assets. It owes senior unsecured creditors \$100 million and junior unsecured

average time from the filing of the case to the confirmation of the plan in the cases we studied was 2.3 years. See LoPucki & Whitford, *Venue Choice*, *supra* note 16, at 31-32.

³⁸⁸ Who "gains" or "loses" from a particular course of action depends on the baseline from which the change is measured. We have selected the prudent investment principle as the baseline for two reasons. First, because it is currently the customary practice, it is likely to be the practice anticipated by debtors and creditors in the bargains that resulted in their extensions of credit. The entitlements it recognizes will come as no surprise. No transitional adjustment will be necessary. Second, using the prudent investment principle as a baseline will make risk compensation payments easier to administer than other possible baselines. Basically, this principle calls on management to continue the company's operations, without liquidating assets, if possible, and without expanding. Consequently, it would be easy to detect deviations from this principle, which would trigger the question whether to make risk compensation payments.

It may seem curious to adopt as a baseline entitlement a distribution that would be received if management adopted an investment policy contrary to the socially desired maximization principle. We have argued, however, that simply directing management to follow a maximization policy without risk compensation payments is likely to be futile. See *supra* note 372 and accompanying text.

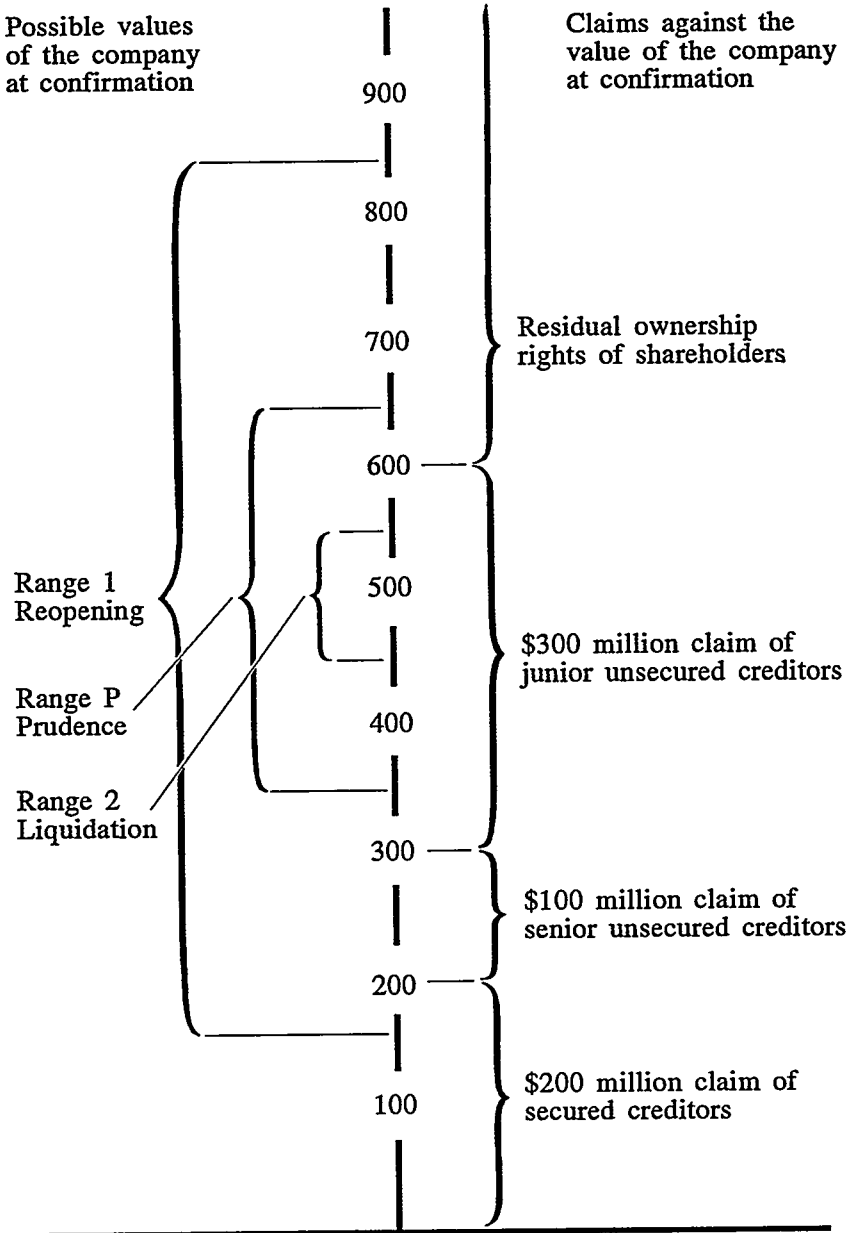
creditors \$300 million, with shareholders having the right to values in excess of those amounts. Assume that if the management of this company pursued a prudent investment strategy, perhaps by reopening under the old format, the possible range of values the company might have by the time a plan is confirmed would be those indicated as "Range P." The expectancies to each of the various parties from each of the possible outcomes within range P, each weighted for the likelihood of its occurrence, would be the baseline entitlements of the parties from which their "gains" and "losses" from the actual investment policy would be calculated.

Assume further that the value of this estate would be maximized by reformatting the restaurants before reopening them, a course of action that would result in the range of possible values indicated in Figure III as "Range 1." That is, if the strategy is highly successful, the value of the company may be in excess of \$800 million; if it fails completely, the value could be less than \$200 million. The proposed reformatting will risk the senior unsecured creditors' entire expectancy and a portion of the secured creditors' expectancy.³⁸⁹ Even under current law, the secured creditors arguably are entitled to adequate protection against the loss of their expectancy.³⁹⁰ Under our proposal, the senior unsecured creditors would also be entitled to protection as well, though the protection would be of a different sort. Their protection would be in the form of risk compensation payments made by the beneficiary of the risk-taking. On the facts shown, the primary payors would likely be the shareholders. The court would order, as compensation for the increased risk imposed on creditors by the reopening of the restaurants, that an appropriate percentage of the interests of the current shareholders be immediately and irrevocably transferred to

³⁸⁹ Under a policy of prudent investment, the value of the company could not fall below \$300 million. Neither senior unsecured creditors nor secured creditors would bear any risk. But under the maximizing strategy of reopening in the new format, both would bear risk.

³⁹⁰ See 11 U.S.C. §§ 361, 362(d) (1988); see, e.g., *Bamerical Mortgage & Fin. Co. v. Paradise Boat Leasing Corp.* (*In re Paradise Boat Leasing Corp.*), 5 B.R. 822, 825 (D.V.I. 1980) (secured creditor entitled to protection against risk that debtor's sole asset, a yacht, would be lost at sea).

FIGURE III
CLAIMS AGAINST POSSIBLE VALUES



specified classes of creditors.³⁹¹ In their additional status as shareholders, the creditor recipients would share in the upside potential of the restaurant reopenings.

Absent compensation to creditors for the additional risks that the maximizing business strategy would impose on them, it would be in the creditors' interest to defeat that strategy. If management could implement the maximizing strategy only if they compensated the creditors, however, the creditors would have little or no incentive to oppose it. Necessarily, the amount of a risk compensation payment, like the amount of an adequate protection payment to a secured creditor, would be only a rough estimate of the amount that would compensate a senior interest for the extra risk assumed. Measurement of such amounts can never be exact. It would defeat the purpose of risk compensation payments to delay an investment decision for an extensive period while the parties litigated about the size of the corresponding risk compensation payment.³⁹² Further, it is better to have payments that are only a rough approximation of the appropriate amounts than to adhere to the current system of noncompensation that sometimes encourages creditors to block management's strategies for maximizing the estate.

Management or any other party in interest should be permitted to ask the court to order a risk compensation payment.³⁹³

³⁹¹ Because the transfer is irrevocable, the creditor recipients will receive more than full payment if the restaurant reopenings prove successful. Thus risk compensation payments will alter what the parties would receive today if management maximized the estate and the absolute priority rule was then applied to the value of whatever the corporation possessed at confirmation. Risk compensation payments differ in this respect from the adequate protection payments received by secured creditors. Adequate protection payments ordinarily are credited against the amount owing and hence reduce what the secured creditors receive at confirmation.

³⁹² It would be possible for a court to direct management to make the maximizing investment while reserving decision on the size of the risk compensation payment. Then litigation about the latter question could take place without delaying actual investments. Such a procedure, however, invites the parties to try to stall the litigation about the size of risk compensation payments, so that the actual results of the investment decision could influence the court to set the amount of the risk compensation payments favorably to them. In the usual case, we suspect it would be better for the court to make a quick, though necessarily rough, estimate of the proper risk compensation payment. If a system of risk compensation payments is adopted, we anticipate that courts will experiment with such details.

³⁹³ Arguably, 11 U.S.C. § 105 (1988) provides sufficient authority for the courts to order risk compensation payments. And 11 U.S.C. § 363 is an existing vehicle by which parties in interest could raise the issue of risk compensation if management failed to do so. However, because risk compensation payments would be novel, we think it would be preferable for Congress to provide a statutory framework for them.

Management might choose to be the moving party when it wished to make the maximizing investment and wanted to free itself from the intense opposition it could expect because of the distributional effects of its proposed actions. We anticipate that under a regime of risk compensation payments, there would be a good deal of bargaining between management and interested parties both about what investment actions management should undertake and what risk compensation payments should accompany those actions. If a consensus resulted from that bargaining, presumably it would then be presented to the court by management for approval.

The logic of our argument implies that if management's pursuit of maximization relieved any class of the risks they would have borne under prudent investment, that class should compensate those whose interests were thereby sacrificed. For example, assume that management concluded that liquidation of the company depicted in Figure III would maximize the estate and that the range of possible liquidation values was the narrow one indicated as "Range 2." By eliminating the possibility that the estate would ever return to solvency,³⁹⁴ the decision to liquidate would render the shareholders' expectancy worthless at the same time that it reduced the risk to the junior unsecured creditors. Therefore, it would be appropriate for the junior unsecured creditors to make a risk compensation payment to shareholders. Such payments would eliminate or minimize shareholder incentives to resist liquidating transactions that in fact maximize the value of the estate.

Though we think the argument is theoretically sound, we consider the case for requiring risk compensation payments to junior classes less compelling. We have two concerns. First, in the cases studied we observed what we considered to be a surprising amount of liquidation.³⁹⁵ In our second best world there may already be an appropriate or even an excessive amount of liquidation.³⁹⁶ Second, deviations from the absolute priority rule in

³⁹⁴ That is, by changing the maximum possible value of the estate from about 660 (the high end of Range P) to about 560 (the high end of Range 2).

³⁹⁵ See *supra* Table VIII accompanying note 290. We report additional information about the typicality of reducing asset size in chapter 11 in LoPucki & Whitford, *Patterns*, *supra* note 16, at 10-12.

³⁹⁶ Even if there is more than an optimal amount of liquidation occurring in reorganization cases generally, it might nevertheless be advisable to require a risk compensation payment to encourage liquidation in a particular case. In deciding whether to order risk compensation payments, the courts should make distinctions among cases.

favor of junior classes are already common.³⁹⁷ We are concerned that risk compensation payments to junior classes may to some degree double compensate them.

We have proposed risk compensation payments as a response to what we and others believe to be a serious problem of non-maximizing business decisions by corporate management in chapter 11 reorganizations. The practicality of risk compensation payments cannot be fully ascertained until the idea is tested. Our proposal has the advantage, however, of falling within the general framework of existing chapter 11. It does not require abandonment of the longstanding idea that sometimes it is in the interests of the bankruptcy estate to preserve the going concern value of assets by reorganizing rather than liquidating the company.

CONCLUSION

There are many similarities between the problems of corporate governance in reorganization proceedings today and those of the 1930s. As under current law, the managements of the 1930s remained in office and directed the reorganization. The basic findings of the *Douglas Report* were that in the 1930s managements possessed a great deal of power and often exercised it in self-serving ways. Management seems to have considerable power under the current Bankruptcy Code as well, because of the debtor-in-possession concept, the infrequency of appointment of trustees, the automatic stay, and the right of exclusivity. At least in some instances, managers in fact have such power and are able to use it in self-serving ways.³⁹⁸

But we found much reason to doubt the currently fashionable view³⁹⁹ that chapter 11 leaves tainted managers with virtually unbridled power. The strongest reason for doubt is the fragile tenure of CEOs in the cases studied.⁴⁰⁰ Nearly all of the CEOs tainted by the firm's failure were out of office by the time a plan was confirmed. Even their successors suffered a high rate of attrition. Many of these CEO changes took place while the company

³⁹⁷ See *supra* note 61.

³⁹⁸ See *supra* notes 229-35 and accompanying text.

³⁹⁹ For example, Bradley and Rosenzweig describe management as being "able to remain in control of a firm's assets without answering to the firm's residual claimants" and therefore being themselves the ultimate residual claimant. See Bradley & Rosenzweig, *Untenable Case*, *supra* note 10, at 1079 n.85.

⁴⁰⁰ See *supra* notes 190-224 and accompanying text, table, and figures.

was in chapter 11. If management has extensive ability to determine the outcome of reorganization proceedings, we would expect that they would also have the ability to retain their own jobs.

We conclude instead that the power equation in the reorganization of large, publicly held companies is far more complex than is reflected in current scholarship. We hope this Article will lay to rest two false but common assumptions that have plagued the economic modeling of bankruptcy reorganization. The first is that management represents the interests of shareholders in these proceedings.⁴⁰¹ The data show that direct alignment of management with shareholder interests in insolvent, reorganizing companies is relatively rare. Equally false, however, is the second assumption sometimes made that once a company becomes insolvent, management thereafter represents creditor interests.⁴⁰² We observed a diversity of management behaviors. No simple proposition can capture the complexity of the system by which these companies are governed.

The reason for this diversity of management orientations in chapter 11 is the complex, multifaceted nature of the process by which reorganizing companies are governed. Managements may be vulnerable to removal by vote of the company's shareholders or by appointment of a trustee upon application of its creditors. Their need for cash to maintain operations may drive them under the hegemony of creditors who are in a position to impose cash demands on the company or make additional cash available. Creditors, shareholders, or other stakeholders may be able to defeat management's initiatives through legal objection, they may be able to exert pressure on management through vexatious litigation, or they may assert that management is their fiduciary. Management's loyalties might be controlled through employment contract incentives, their desire to maintain or reclaim their reputations, or their desire to avoid liability or incarceration. Almost any of these incentives might incline management to exercise their authority in different ways on behalf of different interests in different cases.⁴⁰³ Another layer of complexity is added by the fact that nearly every aspect of the corporate governance process is potentially under the supervision of the bankruptcy judge to whom the case is assigned. But this potential power goes unused in many, if not most, cases.

⁴⁰¹ See *supra* note 8 and accompanying text.

⁴⁰² See *supra* note 9 and accompanying text.

⁴⁰³ See *supra* notes 92-172 and accompanying text.

That is, judges differ widely in the degree to which they will impose themselves into the affairs of the reorganizing company, particularly with regard to its business plan.

In reporting this diversity of management behaviors, we do not mean to imply that management orientation results from random processes about which no generalizations can be drawn. First, based on findings that the managements of solvent⁴⁰⁴ companies never aligned with creditors and that the managements of insolvent companies often did so,⁴⁰⁵ we conclude that management orientation is to some degree a function of solvency.⁴⁰⁶

Second, with respect to the conduct of the business during reorganization, we conclude that it is common practice for managements to follow a principle we call "prudence." In essence, managers put the company in a holding pattern until the parties reach agreement. Though there are exceptions, most managements initially seek to preserve the company and avoid the liquidation of major assets. In nearly all cases, they avoid risky new business initiatives that could lead to major gains or losses.⁴⁰⁷ Both tendencies are disturbing. Because of the highly conflicted environment of a chapter 11 proceeding, managements are systematically avoiding actions necessary to maximize the value of the firm.

The most difficult question is the normative one. For whose benefit *should* management govern in a chapter 11 reorganization? The problem is acute for insolvent or marginally solvent companies, because the risk of future loss is likely to be borne by different parties than enjoy the prospect of future gain. Underwater interests bear little or none of the risk of additional loss, and a management devoted to their interests will be inclined toward high risk investment decisions. But senior creditor interests bear most or all of the risk of loss and may benefit little from the upside potential of a new investment policy. A management devoted to their interests will be inappropriately risk-averse.

⁴⁰⁴ Solvency was measured at the time of confirmation.

⁴⁰⁵ The managements of insolvent companies directly aligned themselves with shareholder interests only when there was a single shareholder who held a major block of shares and was represented on the board of directors. See *supra* note 243 and accompanying text.

⁴⁰⁶ The relationship is far from perfect. We observed many cases in which the managers of insolvent companies did not align themselves with creditor interests, either directly or indirectly.

⁴⁰⁷ See *supra* notes 251-58 and accompanying text.

We reviewed the proposal to separate the management of the assets from the reorganization by requiring a speedy auction and found the proposal wanting for several reasons.⁴⁰⁸ We also canvassed a number of proposals for clarifying the uncertain obligations of management in a reorganization proceeding. We found them wanting as well, primarily because they do not adequately assure that management will maximize the value of the company's assets, normally the most important objective in the reorganization of large companies.⁴⁰⁹

We conclude that the best proposal for maximizing the value of the company's assets is the most direct: adopt a rule requiring that management do so. In the conflicted governance environment we describe, however, simply prescribing that management choose wealth maximization over loyalty to any particular interest will neither cause nor enable them to do so. The pursuit of wealth maximization by a reorganizing debtor can have important distributional effects. When, for example, the maximizing business plan calls for a high-risk business expansion or acquisition during reorganization, adopting it may sharply diminish the value of the creditors' claims. That threat of diminution gives creditors the incentive to oppose maximization, and the process of corporate governance will often provide them with the means. As the system currently operates, management will find it difficult or impossible to pursue the maximizing expansion or acquisition.

To lessen the creditors' incentives to oppose management efforts to maximize the value of the firm, we have advanced a novel proposal that bankruptcy courts order payments from the groups who stand to benefit from maximization to compensate the creditors who are required to bear the risk.⁴¹⁰ These "risk compensation payments" would consist of a transfer of an appropriate portion of the interests of junior classes who stand to benefit from the business initiative, to the senior classes who will be disadvantaged by it. The primary purpose is to reduce the incentives for senior creditor interests to resist maximizing business expansions or acquisitions.

⁴⁰⁸ See *supra* notes 270-308 and accompanying text.

⁴⁰⁹ See *supra* notes 317-53 and accompanying text.

⁴¹⁰ We also urge that bankruptcy courts do whatever they can to shorten chapter 11 proceedings in order to reduce as much as possible the period of time when management incentives to maximize are compromised by their conflicted environment in bankruptcy. See *supra* notes 376-80 and accompanying text.

There are obvious problems in implementing the risk compensation concept, but we think it is a worthwhile improvement. In the absence of this reform, we anticipate that most managements will continue the current practice of avoiding both early liquidation and high risk business expansions or acquisitions while in reorganization. In following what we have called the principle of prudent investment, they will be insuring that the social costs of bankruptcy remain unnecessarily high.⁴¹¹

⁴¹¹ See *supra* note 267 and accompanying text.