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Jonathan C. Lipson

*University of Pennsylvania (Visiting)*

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WHERE'S THE BEEF? A FEW WORDS ABOUT PAYING  
FOR PERFORMANCE IN BANKRUPTCY

JONATHAN C. LIPSON<sup>†</sup>

In response to Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777 (2007).

Few business law subjects get jaws flapping like executive compensation. When we see Michael Ovitz and Robert Nardelli receive millions of dollars—for doing a *bad* job—we have to wonder whether our system's incentives might be askew.<sup>1</sup> Indeed, some of our best recent business law scholarship wrestles with the difficult questions posed by executive compensation, which, to paraphrase Bebchuk and Fried, reduce to this: How do we link pay to performance?<sup>2</sup>

Yair Listokin has invited us to map this discussion onto the question of executive compensation in Chapter 11 reorganization.<sup>3</sup> It is a welcome invitation, because there is doubtless value in thinking carefully and creatively about improving incentives for those in control of a debtor in possession (DIP) in reorganization under Chapter 11.<sup>4</sup>

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<sup>†</sup> Visiting Professor of Law, University of Pennsylvania Law School, 2007; Professor of Law, Temple University—James E. Beasley School of Law. This Response benefited from very thoughtful comments from Robert Rasmussen, as well as conversations with The Honorable Elizabeth Snow Stong, United States Bankruptcy Judge for the Eastern District of New York. All defects are, of course, my responsibility. © 2007 Jonathan C. Lipson, all rights reserved.

<sup>1</sup> See *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (2006) (upholding Ovitz's severance package valued at approximately \$130 million); *Nardelli's 'Severance'*, WALL ST. J., Jan. 5, 2007, at A12 (announcing Nardelli's \$210 million severance package).

<sup>2</sup> See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 189-90 (2004) ("Well-designed executive compensation can provide executives with cost-effective incentives to generate value for shareholders. Unfortunately, the promise of such arrangements has not yet been fully realized.").

<sup>3</sup> Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777, 783 (2007).

<sup>4</sup> Numerous sections of the Bankruptcy Code were amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18, and 28 U.S.C.).

Large corporate debtors are, like all large (and small) corporations, ultimately run by human beings. Being fallible, greedy, and complex, one easily could imagine that the people who manage Chapter 11 debtors might engage in the same sort of agency arbitrage that we see between the managers of large publicly held corporations and those corporations' widely dispersed shareholders. Although management agency costs are well studied outside of bankruptcy,<sup>5</sup> they have gone largely unnoticed in bankruptcy scholarship in recent years.<sup>6</sup> That Listokin wishes to "reorient the scholarly debate in bankruptcy toward the problem of executive compensation" is good news.<sup>7</sup>

In simple terms, Listokin believes that properly constructed incentive compensation packages would promote effective management and constrain agency problems in Chapter 11 reorganizations by empowering creditors' committees to pay management with corporate debt. This would align the interests of management with those of the "true" residual claimants of the reorganizing debtor—the unsecured creditors. Listokin would thus give to the creditors' committee the right effectively to assign to management a portion (a "vertical strip") of the corporation's debt as part of management's compensation.<sup>8</sup>

There is much about Listokin's article that is valuable. He provides a rigorous economic analysis of some of the unexpected implications of incentive compensation in reorganization. He shines considerable light on a rather dim corner of bankruptcy and corporate governance. Perhaps more importantly, he sets the stage for further

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<sup>5</sup> The locus of most discussions of agency cost is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

<sup>6</sup> This is not to say that we lack *any* data. Somewhat surprisingly, Listokin fails to cite two important empirical studies of executive compensation in bankruptcy. See Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 J. FIN. 425, 425 (1993) (analyzing "senior management compensation policy in 77 publicly traded firms that filed for bankruptcy or privately restructured their debt to avoid bankruptcy during 1981 to 1987"); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 673 (1993) (showing "empirically that neither the assumption of shareholder control nor the assumption of creditor control is correct"). While executive compensation practices have undoubtedly changed in the years since these studies were published, many of the underlying problems have not.

<sup>7</sup> Listokin, *supra* note 3, at 783.

<sup>8</sup> See *id.* (proposing this "novel form of managerial incentive compensation for publicly traded corporations in bankruptcy").

inquiry.<sup>9</sup> But I also have doubts and concerns. I am persuaded neither that there is much of a problem, nor by the solution he proposes.

### I. WHAT'S THE PROBLEM? WHERE'S THE BEEF?

Listokin starts from two seemingly incompatible assumptions: (1) management compensation in reorganization is needlessly restricted;<sup>10</sup> and yet, (2) the current menu of compensation schemes in bankruptcy creates the wrong incentives and may be subject to managerial manipulation.<sup>11</sup> The problem with the first assumption is that it lacks empirical support; the problem with the second is that, while it may be true outside of bankruptcy, Listokin has not demonstrated that it pertains within bankruptcy.<sup>12</sup>

#### A. Needlessly Restricted Compensation

Listokin assumes that there are needless constraints on management compensation in reorganization. He notes that management compensation in bankruptcy, as currently conceived, might take one of three general forms: (1) cash “pay-to-stay” bonuses (sometimes known as “key employee retention plans,” or KERPs);<sup>13</sup> (2) rapid-reorganization bonuses,<sup>14</sup> and (3) shares of firm value.<sup>15</sup>

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<sup>9</sup> As if passing Listokin in the night, M. Todd Henderson, of the University of Chicago, recently posted a draft article entitled *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low* (John M. Olin Program in Law & Econ. Working Papers (2d series), Paper No. 306, 2006), available at [http://ssrn.com/abstract\\_id=927081](http://ssrn.com/abstract_id=927081). Rather than looking for lessons about bankruptcy in corporate governance literature, however, Henderson uses bankruptcy cases—where, he claims, “agency costs are dramatically reduced as sophisticated investors consolidate ownership interests”—to argue that, *ergo propter hoc*, “reducing agency costs does not cause material changes in the fundamental nature of compensation bargains.” *Id.* at 3. So far as I can tell, neither Listokin nor Henderson cites the other.

<sup>10</sup> Listokin, *supra* note 3, at 779 & n.1 (citing DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 183 (3d ed. 2001)).

<sup>11</sup> *Id.* at 782-83.

<sup>12</sup> Nor has he explained how both could be true at the same time: the former, if true, would tend to undercut the latter.

<sup>13</sup> Listokin, *supra* note 3, at Part II.B.1. Amended section 503(c)(1) of Chapter 11, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 331, 119 Stat. 23, 102, prohibits the allowance and payment of sums to insiders “for the purpose of inducing such person to remain” with the business “absent a finding by the court based on evidence in the record” that (1) the payment is “essential” to the retention of the individual “because the individual has a bona fide job offer from another business at the same or greater rate of compensation”; and (2) the services of that individual are “essential to the survival of the debtor’s business.”

<sup>14</sup> Listokin, *supra* note 3, at Part II.B.2.

This set of choices is problematic, Listokin argues, because some or all of these mechanisms may “skew” incentives.<sup>16</sup> Managers may receive cash awards to stay with the firm through bankruptcy, and then receive a better offer and leave, keeping (or already having spent) the KERP payment. Managers may propose strategies that overvalue or undervalue the firm, that seek liquidation when reorganization would be optimal, or vice versa, and so on. Yet, while these problems may exist in theory, they do not appear to exist in practice—at least not in the ways Listokin imagines.

Consider first the legal constraints on incentive compensation. Recent amendments to the Bankruptcy Code—new section 503(c), to be specific—do, in theory, make certain types of compensation plans (in particular, KERPs) more difficult for DIPs to adopt. But, if recent cases are any indication, courts appear willing to tolerate creative attempts to circumvent the statute.<sup>17</sup>

In the *Dana* case decided last fall, for example, the DIP initially proposed an executive retention plan to which a number of parties objected.<sup>18</sup> Judge Lifland denied the motion as violating section 503(c) because, among other reasons, it guaranteed management a completion bonus and set bonus targets too low.<sup>19</sup> The parties—in particular, the DIP and the committees—thereafter met and negotiated a resolution. The DIP then asked the court to reconsider its original denial of the motion, on the theory that there was substantial agreement by the parties. Judge Lifland denied that request as moot,

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<sup>15</sup> *Id.* at Part II.B.3-4 (referring to such plans as “percentage-of-assets” and “proportion of equity” compensation plans).

<sup>16</sup> *Id.* at Part II.B.

<sup>17</sup> See, e.g., *In re Dana Corp.*, No. 06-10354 (BRL), 2006 WL 3479406, at \*5 (Bankr. S.D.N.Y. Nov. 30, 2006) (“[S]ection 503(c) was not intended to foreclose a Chapter 11 debtor from *reasonably* compensating employees, including ‘insiders,’ for their contribution to the debtors’ reorganization.”). I will refer to this decision as *Dana II*, even though I cite it first, because it is the latter of two important opinions in the case on the same issue—namely, whether a KERP was “subject to limitations of section 503(c) of the Bankruptcy Code or can . . . be construed to be an *incentivizing* ‘Produce Value for Pay’ plan to be scrutinized through the business judgment lens of section 363?” *In re Dana Corp.*, 351 B.R. 96, 98 (Bankr. S.D.N.Y. 2006) [hereinafter *Dana I*].

<sup>18</sup> *Dana I*, 351 B.R. at 98. Objections “were filed by the Creditors’ Committee, the Ad Hoc Noteholders’ Committee, the Equity Committee, the United Aerospace and Agricultural Implement Workers of America (the “UAW”) and United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial Service Workers International Union (the “USW”) and the United States Trustee.” *Id.*

<sup>19</sup> *Id.* at 102, 103.

but he effectively upheld the revised plan because it contained “many modifications, changes and alterations.”<sup>20</sup>

It would be one thing if Listokin were arguing that statutory changes that limited KERPs imposed needless costs on reorganization by deterring good candidates or requiring more professional (e.g., lawyer) time and expense. But, so far as I can tell, that is not his concern.<sup>21</sup> Rather, his concern is largely theoretical, organized around the presumed behavior of managers of an insolvent debtor with an exceedingly simple capital structure.<sup>22</sup> In many respects, his analysis is similar in tone and texture to Chancellor Allen’s famous hypothetical in the *Credit Lyonnais* case, in which corporations are assumed to have very simple capital structures and implausibly clear options.<sup>23</sup> Such corporations would be run by agents who would act on these options as the predictable “homo economicus” might.<sup>24</sup> The problem, of course (as discussed further below), is that the real world—where

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<sup>20</sup> *Dana II*, 2006 WL 3479406, at \*4. Judge Lifland continued: “The plan before the Court today, unlike the previous iteration, has *no guaranteed payments* to the CEO or Senior Executives other than base salary and is a substantial retreat from the original proposals.” *Id.*

<sup>21</sup> Listokin does cite the statute and mention its constraints. See Listokin, *supra* note 3, at 780 n.6 (citing 11 U.S.C.A. § 503(c)(1) (West, Supp. 2006) and Jason S. Brookner, *Law Limits Executive Compensation*, TEX. LAW., May 29, 2006, <http://www.law.com/jsp/tx/PubArticleTX.jsp?id=1150275918997>).

<sup>22</sup> See Listokin, *supra* note 3, at Part II.A–B.1 (discussing incentives created by DIP financing and managerial “pay-for-performance” plans).

<sup>23</sup> *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at \*108 n.55 (Del. Ch. Dec. 30, 1991). Chancellor Allen’s hypothetical analysis of a corporation in financial distress assumes a corporation with a single asset—a significant judgment (on appeal) against a solvent corporation—and a very simple capital structure. Chancellor Allen speculated on the level of risk the board of the distressed corporation should undertake, concluding, in essence, that directors of a distressed (but not necessarily insolvent) corporation should be free to take more conservative action than might otherwise ordinarily be expected. *Id.* This is so because the board is at risk of playing with other peoples’ money. I offer lengthy assessments of the strengths and weaknesses of *Credit Lyonnais* in Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1208-1229 (2003) [hereinafter Lipson, *Directors’ Duties*], and Jonathan C. Lipson, *The Expressive Function of Directors’ Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. (forthcoming 2007) (draft of Feb. 16, 2007, manuscript at pp. 12-20, on file with author).

<sup>24</sup> “Homo economicus” is shorthand for the sort of rational self-maximizer on which traditional price-based economic theory depends. This rational self-maximizer has taken a pummeling in recent years, as many scholars have argued that people do not, and should not be expected to, act in these ways. See generally Lynn A. Stout, *On the Proper Motives of Corporate Directors (or, Why You Don’t Want To Invite Homo Economicus To Join Your Board)*, 28 DEL. J. CORP. L. 1, 24-25 (2003) (asserting that the *homo economicus* model of corporate behavior should be abandoned to reflect the possibility of altruistic behavior).

Listokin presumably wants his proposal to be digested—is not so simple.

Similarly, Listokin assumes that the existing tools available to parties in reorganization are inadequate. But there is no apparent reason why a plan of reorganization could not already achieve what I think is his real goal—treating management compensation as *pari passu* with unsecured creditors' claims. A reorganization plan could certainly issue to managers some of the same consideration that creditors receive.<sup>25</sup> This is a point Listokin appears to concede.<sup>26</sup>

If his claim is instead that the failure is one of imagination—not one of the legal system as it currently exists—then he must answer what is sometimes called the “Chicago” question, namely: why don't we do this already? If, as he seems to assume, we are rational self-maximizers, and the law has not kept debt compensation out of the reorganization toolbox, what has? If the answer is “nothing,” then perhaps the market has no appetite for his offering.

### B. *Thieving Managers*

Listokin's second problematic assumption is that management could somehow get away with manipulating firm value under the current regime.<sup>27</sup> Because managers have “the best information about the company's true value,” Listokin fears that they will misstate firm value and “wreak havoc with the courts' ability to ensure that § 1123(a)(4) is observed.”<sup>28</sup> But this embeds a number of questionable subsidiary assumptions. First, bankruptcy reorganization necessarily involves a number of players who typically devote a significant

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<sup>25</sup> See 11 U.S.C.A § 1123(b)(6) (2006) (stating that reorganization plans may “include any other appropriate provision not inconsistent with the applicable provisions of this title”).

<sup>26</sup> See Listokin, *supra* note 3, at 801 (“Upon confirmation of a reorganization plan, the manager would receive the given percentage of whatever amount the original creditors receive in lieu of debt.”). In fairness, Listokin may mean that the *grant* would occur at the outset, while the *payout* would come only at confirmation. Unfortunately, his proposal (or at least the version we saw) was not specific on timing. While a pre-plan grant would be innovative, it would also be problematic, for the reasons discussed in Part II, below.

<sup>27</sup> See Listokin, *supra* note 3, at 795 (“Equity compensation plans . . . give managers incentives to understate the value of equity in order to get a plan confirmed that maximizes the value of the manager's stake in the reorganized company's equity.”).

<sup>28</sup> *Id.* at 795-96. Section 1123(a)(4) requires a reorganization plan to “provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment.” 11 U.S.C.A § 1123(a)(4) (2006).

amount of time to understanding firm value, which (as discussed further below) is itself a complex proposition. DIP lenders, unsecured creditors' committees, and—perhaps more importantly—the professionals they hire, all usually receive substantial amounts of information about the DIP as it attempts to reorganize. Therefore, it seems highly unlikely that managers would be able to manipulate firm value undetected.

Listokin also assumes that managers would want to do this. Yet he ignores the fact that, in many cases, creditors will have played a role in hiring managers in the first place. Often, reorganizing firms use “turnaround” professionals, also called “chief reorganization officers” (CROs), recommended by creditors.<sup>29</sup> CROs usually do not remain with the corporation in the event that it reorganizes successfully. Their job is to right the ship, and to pass the firm to someone who will manage it for the long haul. They are scrutinized by bankruptcy judges, the United States Trustee, and all of the other repeat players in these cases (in particular, other professionals). It is unlikely that these turnaround experts could afford to anger them by fudging the firm's books.

This possibility suggests the more general flaw in Listokin's assumptions. Reorganization under Chapter 11 introduces a number of unique checks and balances into the management of the firm. Indeed, one of the reasons managers often want to keep a distressed company out of bankruptcy is to avoid the added levels of scrutiny and process imposed in the “fishbowl” of bankruptcy proceedings. Listokin could argue that these checks and balances somehow interfere with optimal compensation structures in reorganization, but he does not. Perhaps he does not because, so far as we can tell, they create no significant problems.

This should not suggest that bankruptcy is free from agency conflicts, or that Listokin's reckoning of the costs created by these conflicts is unwelcome. Indeed, if we are to continue to introduce greater market incentives into reorganization, we might see more of the agency problems we already find in the larger economy. But today, I am not persuaded by his assumptions or characterization of the problem.

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<sup>29</sup> Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1233-34 (2006) (discussing the role of CROs and observing that “banks may condition the waiver of loan covenants on the appointment of a CRO”).



## II. WHAT'S THE SOLUTION?

If one nevertheless believes there is a problem, Listokin has a solution: give creditors' committees the power to pay management with corporate debt (the "proposal").<sup>30</sup> As he explains:

[I]f the majority of the members of the committee approve a given percentage of debt compensation and the percentage meets a number of guidelines detailed later in this Article, then the manager should receive the given percentage of all the noncontingent unsecured claims on the company. Upon confirmation of a reorganization plan, the manager would receive the given percentage of whatever amount the original creditors receive in lieu of debt. For example, if debt in the original company is transformed into equity in the reorganized company, then the manager would receive a percentage of equity, and if the unsecured debt is transformed into debt in the reorganized company, then the manager would receive a percentage of this debt claim.<sup>31</sup>

Boiled down, there are three key ingredients in the proposal: (1) the creditors' committee would have something that it could use to encourage ("incent," in the vernacular) management; (2) this incentive would come in the form of a currency that rendered some portion of executive compensation *pari passu* with unsecured creditors; and (3) it would be the creditors' own money, in a sense, that they were spending. I consider each of these elements in turn.

### A. *The Creditors' Committee*

Consider first the notion that we would vest creditors' committees with some real, positive incentive to work with. For the most part, creditors of a Chapter 11 debtor have very limited tools to motivate and discipline management. Individual creditors can do virtually nothing, especially if they are unsecured. Creditors' committees may investigate and consult, but—at least as a statutory matter—their powers are stated entirely in the conditional and therefore are limited. Specifically, a creditors' committee

*may*—(1) consult with the . . . debtor in possession concerning the administration of the case; (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor . . . ; (3) participate in the formulation of a plan . . . ; (4) request the appointment of a trustee or

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<sup>30</sup> See Listokin, *supra* note 3, at 800 ("To improve managerial performance, I propose that the committee be granted the right to award managers a percentage of the unsecured debt of the insolvent firm.")

<sup>31</sup> *Id.* at 801 (footnotes omitted).

examiner . . . ; and (5) perform such other services as are in the interest of those represented.<sup>32</sup>

None of these is a positive incentive for management, and, with the exception of (4), none is likely to give management much cause to worry. Even (4), which permits the appointment of a trustee or examiner (also known as the “nuclear option”), may be so harsh that no creditors’ committee really wants to use this power. Nowhere is a committee, as such, given the power to “incent” management positively with the promise of, for example, money or other things of value.

Listokin’s proposal would change this by giving unsecured creditors’ committees the power of the purse. This is perhaps the most intriguing feature of the proposal, because it would be a further (perhaps inexorable) step toward the contractualization of bankruptcy. If we believe that reorganization should exhibit greater market tendencies, this might be a step in the right direction.<sup>33</sup> The proposal would give creditors’ committees greater leverage in negotiations with participants in the debtor’s reorganization, including DIP lenders, secured creditors, and existing equity holders, all of whom have various tactical strengths but none of whom can directly compensate management.

One of the more interesting questions raised by the proposal is the effect it would have on relations with professionals. It is reasonably well accepted that professionals—primarily lawyers and accountants—play an important role in reorganization. Their services are not free, and the cost of their services has been cited as one of the reasons reorganization was historically viewed as an inefficient mechanism for resolving corporate financial distress. If creditors’ committees were given the proposed form of currency to spend, perhaps they would be less dependent on their professionals. If committees were less de-

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<sup>32</sup> 11 U.S.C.A. § 1103(c) (2006) (emphasis added).

<sup>33</sup> A running debate about bankruptcy, as in most discussions about private ordering, concerns the role of contract. Several prominent scholars—notably Barry Adler and Alan Schwartz—have offered thought-provoking proposals for the use of contracts that would, at least in theory, produce more efficient results than those that are obtained under the existing legal regimes that govern or influence bankruptcy reorganization. See, e.g., Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 352 (1997) (developing a proposal for the use of pre-bankruptcy contracts that would use “Chameleon Equity,” stock that would automatically be crammed down by creditors’ claims in the event of insolvency); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 210-11 (1989) (developing a proposal to permit creditors to obtain priority purely by contract).

pendent on professionals, perhaps the professionals would feel less temptation to run up the tab.<sup>34</sup>

Listokin does not explain in great depth the novelty or implications of this piece of his proposal, but it is fascinating, as it suggests a new basis for thinking about how to generate incentives in reorganization.

### B. *Pari Passu Treatment*

The heart of the proposal is that some portion of executive compensation should be more or less *pari passu* with the “true” residual claimants, who are probably the unsecured creditors. By giving management a “vertical strip” of unsecured creditors’ claims, management’s incentives would be properly aligned.

The problem is that bankruptcy is a game of uncertain fractions. The numerator will be the debtor’s assets, and the denominator will be claims against the debtor. Because the denominator is likely larger than the numerator, creditors can expect to receive only a fraction of their claims. But in reorganization, both numbers are exceedingly difficult to pin down. In the case of assets, corporations can have extremely complex interests that are highly speculative, or simply too costly to value. Who really knew what Enron’s assets were worth at the commencement of its reorganization, when management was to be retained? Would it have been worthwhile to figure this out?

We can identify similar problems with the denominator. The DIP is supposed to file schedules of assets and liabilities when it commences a case.<sup>35</sup> The stated amount of a claim will be binding on the creditor unless the creditor files a proof of claim in some different amount before the bar date, at which point the debtor and creditor may either litigate or settle the claim.<sup>36</sup> In order to have a reasonable handle on the true value of the debtor’s debts—and, therefore, to decide whether to accept or reject Listokin’s proposal—a prospective manager would need some understanding of the amount of that debt.

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<sup>34</sup> I hasten to add that I am not at all sure professional compensation is necessarily a problem. Professionals are subject to many of the same checks and balances that govern DIP management.

<sup>35</sup> 11 U.S.C.A. § 521(1) (2006).

<sup>36</sup> 11 U.S.C.A. §§ 502(a), 1111(a) (2006). Bankruptcy Rule 3003(b)(1) provides that “the schedule of liabilities filed pursuant to § 521(1) of the [Bankruptcy] Code shall constitute prima facie evidence of the validity and amount of the claims of creditors, unless they are scheduled as disputed, contingent, or unliquidated.” FED. R. BANKR. P. 3003(b)(1).

Should she look to the schedules? Should bar dates now come as first-day orders? Listokin does not say.

This problem is not merely practical; it also suggests that the proposal flunks the economic theory on which it rests. This is because there is probably an inverse relationship between the cases where the proposal is possible and the cases where it would be worthwhile. If the capital structure is really as simple as Listokin's model assumes, how good (i.e., expensive) will management need to be? Simple structures suggest simple cases—and therefore simple (i.e., inexpensive) management.

If, however, we are running a railroad (or airline) in bankruptcy, who is going to spend the time and money to do a meaningful valuation of such a complex corporation at the outset, which is when it would have to occur? If the answer is, as I suspect, no one, then management would be taking compensation with fairly speculative value. Is that the sort of management we would want in a complex reorganization? I don't think so.

### C. *Other People's Money*

The third element of the proposal is perhaps the most troubling, in that the creditors' committee would be using other creditors' "money." While using this incentive would avoid a variety of collective action issues, it also would create at least four problems.

First, it is not, in fact, the creditors' committee's money to use. Listokin claims that giving a committee the power to bind other creditors "is not a radical idea."<sup>37</sup> He analogizes creditors to shareholders who "cannot opt out of stock option plans. Instead, the shareholders are bound by the decision of the board of directors."<sup>38</sup>

Here, he runs into trouble, confusing dilution with defeasance. Corporate boards may have the authority to issue stock or options to management, diluting shareholders' rights. But that is not what the proposal does. It does not *dilute* the value of unsecured claims; it takes a share of those claims away, even from creditors who do not agree with the implementation of the proposal. I am aware of no state-law authority that would permit, in the executive compensation

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<sup>37</sup> Listokin, *supra* note 3, at 816.

<sup>38</sup> *Id.*

context, a board of directors to do this without shareholder approval.<sup>39</sup>

Second, and perhaps more importantly, shareholders have a variety of checks on directors not available to creditors represented by an unsecured creditors' committee. Shareholders usually have the right to elect directors; creditors' committees, by contrast, are appointed by the United States Trustee. Moreover, while creditors' committees may be viewed as fiduciaries in certain respects, as a practical matter, directors are probably subject to better-defined fiduciary standards vis-à-vis shareholders (even if outside bankruptcy they may be subject to management capture).

Third, Listokin writes as if all unsecured creditors were more or less normatively the same. But, of course, many creditors have not chosen to extend credit—terminated employees and tort creditors come to mind. It seems one thing to give away a percentage of a contract creditor's debt, and another to do that to an involuntary creditor.<sup>40</sup> Unfortunately, Listokin's proposal does not differentiate among creditors, except as to priority.

This brings us to the final problem: the proposal fails to account for the way priority really works among unsecured creditors. Listokin suggests that senior unsecured creditors should have the right to opt out of the proposal.<sup>41</sup> This may make theoretical sense (junior creditors should not give away senior creditors' money). It ignores, however, the fact that identifying the senior unsecured creditor will often be even more difficult than identifying the hypothetical residual claimant (i.e., the most junior creditor).

When unsecured creditors are parties to "senior" credit arrangements, they will not necessarily obtain contractual priority over *all* general unsecured creditors; they will have priority over only those parties who have expressly agreed to subordinate their claims to those

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<sup>39</sup> Even Delaware, surely more director-friendly than many jurisdictions, would forbid this. See DEL. CODE ANN. tit. 8 § 242(b)(2) (2001) (giving a class vote to shareholders where a proposed charter amendment would "alter or change the powers, preferences, or special rights of 1 or more series of any class so as to affect them adversely").

<sup>40</sup> See Lipson, *Directors' Duties*, *supra* note 23, at 1242-51 (discussing variations in "volition, cognition, and exit" among corporate creditors).

<sup>41</sup> Listokin, *supra* note 3, at 812 ("Senior unsecured creditors should be allowed to 'opt out' (as a group) of the debt compensation package.").

senior creditors.<sup>42</sup> Thus, it will usually be much easier to identify *junior* unsecured creditors than senior unsecured creditors. Junior creditors are creditors who contractually subordinate their claims to those of the senior creditors. For this reason, we sometimes call their debt “junk” (or, if you work in the marketing department, “high yield”).

Listokin makes this concession to senior creditors based, in part, on the supposition that senior unsecured creditors are “likely” to have their own committees.<sup>43</sup> I am aware of no empirical studies on this (and Listokin cites none), but it seems unlikely that in all but the most unusual cases there would be separate committees of *senior* unsecured creditors—in part because they are so hard to identify.

#### CONCLUSION

My skepticism about Listokin’s proposal does not dilute my respect and admiration for his effort. His contribution is part of an important line of creative attempts by theoreticians to grapple with the exceedingly complex dynamics of financial distress in general, and reorganization in particular.<sup>44</sup> He has produced an interesting and thought-provoking proposal that attempts to address a matter that certainly promises to be more, rather than less, challenging as we go forward. While he may not have found the right beef about executive compensation in reorganization, he has assuredly given us food for thought.

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<sup>42</sup> See 11 U.S.C.A. § 510(a) (2006) (“A subordination agreement is enforceable in a case under [Chapter 11] to the same extent that such agreement is enforceable under applicable nonbankruptcy law.”).

<sup>43</sup> Listokin, *supra* note 3, at 813.

<sup>44</sup> For examples of others’ proposals, see sources cited *supra* note 33.