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PAYING FOR PERFORMANCE IN BANKRUPTCY: WHY CEOS SHOULD BE COMPENSATED WITH DEBT

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While managerial performance always plays a critical role in determining firm performance, a manager's importance is elevated during bankruptcy. A manager in bankruptcy both runs the firm and helps form a plan of reorganization. In light of this critical role, one would expect that bankruptcy scholarship would place considerable emphasis on the role of CEO compensation in incentivizing managerial performance in bankruptcy; however, the opposite is true. Bankruptcy scholars and practitioners tend to emphasize other levers of corporate governance, such as the role of debtor-in-possession financiers, rather than the importance of CEO compensation. This Article seeks to revive CEO compensation as an important governance lever in bankruptcy. First, the Article examines current ideas and practices of managerial compensation in bank-

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ruptcy and finds them wanting. The Article next proposes a novel bankruptcy compensation plan—debt compensation—that provides better incentives for managers to perform efficiently. By granting managers a fixed proportion of unsecured debt in the bankrupt firm, debt compensation creates value-enhancing incentives similar to the incentives created by the stock grants and stock options that are heavily employed by solvent firms to compensate managers.

INTRODUCTION

While managerial performance always plays a critical role in determining firm performance, a manager assumes a heightened role in bankruptcy. In bankruptcy, the manager in control of the debtor-in-possession makes all the decisions that the manager of an ordinary firm must make regarding firm operations and strategy; however, the manager's role does not end there. Instead, the manager also plays an essential role in forming a plan of reorganization or liquidation. This task involves many responsibilities, including weighing the choice of liquidation versus reorganization, mediating between different classes of creditors, and selecting the optimal capital structure for the reorganized firm.

How unfortunate, then, that managerial compensation in bankruptcy is so restricted. While managers of ordinary firms receive a wide array of incentive compensation devices, compensation for a manager in bankruptcy is far more ineffectual and limited.[1] In addition, managerial interests tend to be "closely aligned with the shareholders,"[2] making it unlikely that a manager will design a reorganiza-

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[1] *See, e.g.*, DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 183 (3d ed. 2001) ("The usual checks that keep the managers of a firm in line—the prospects of profits from their equity interests . . . are displaced once a bankruptcy petition is filed.").

[2] *Id.* at 182.

tion plan that maximizes value for the creditors of an insolvent firm. The limitations of executive compensation in bankruptcy are echoed by the lack of scholarly attention to the subject. While the question of executive compensation is the subject of a vast literature in both finance and law,[3] analyses of corporate governance in bankruptcy tend to give the subject short shrift.[4] In an important exception to the pattern of downplaying the role of executive compensation in bankruptcy, Professor David Skeel details some managerial compensation schemes that are prevalent in bankruptcy.[5] These include "pay-to-stay" agreements to retain key managers in the wake of a bankruptcy declaration[6] and managerial bonuses for speedy reorganization. In

[3] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1-12 (2004) (summarizing and critiquing the accepted theories of excecutive compensation, and referring to both the finance and legal literatures on point).

[4] *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 693-99 (2003) (arguing that creditors enjoy considerable power in bankruptcy); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211 & n.4 (2006) (emphasizing the role of creditor monitoring in bankruptcy and contrasting that with the emphasis on matters of executive compensation outside of bankruptcy); Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425, 456-57 (2006) (book review) (stating that "[debtor-in-possession] financing is now the most important corporate governance lever in Chapter 11" and remaining silent on the topic of executive compensation). An important exception to this trend is David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 920, 943-49 (2003), which addresses the "fairness and efficiency concerns" involved with both pre-bankruptcy executive compensation packages, as well as those offered after a bankruptcy petition has been filed. There is no doubt that creditor controls over bankrupt corporations and managers constitute an important governance lever. Creditor control is no panacea, however, as managers will inevitably have some discretion in making choices (otherwise they could not "manage").

[5] *See* Skeel, *supra* note 4, at 926-30. Even this article, however, pays more attention to debtor-in-possession (DIP) financing than to executive compensation. *Id.*

[6] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) sharply limits the use of pay-to-stay agreements. *See* 11 U.S.C.A. § 503(c)(1) (West Supp. 2006) (providing that the debtor shall not make payments to insiders such as executives "for the purpose of inducing such person to remain with the debtor's business"). BAPCPA excepts from this rule situations where a court has expressly found (1) that "[t]he payment or obligation is essential to keep the person from accepting a bona fide job offer for the same or greater pay;" (2) that "[t]he person's continued retention is essential to the survival of the business;" and (3) that "[t]he amount of the payment to be made or obligation to be incurred does not exceed either 10 times the amounts paid to nonmanagement employees in the same calendar year or 25 percent of the amounts paid to insiders in the calendar year preceding that in which the payment is to be made." Jason S. Brookner, *Law Limits Executive Compensation*, TEX.

addition, Professor Skeel mentions proposals for improving these compensation schemes. Skeel states that the ideal solution would be to "base the managers' pay on the overall value of the debtor's assets at the conclusion of the Chapter 11 case."[7] Skeel explains that because of uncertainties regarding valuation, however, this solution will only be attainable when firm value is reasonably well established, such as in liquidation.[8] Instead, Skeel proposes granting stock in the reorganized company to managers; in this way, managers will have incentives to maximize value.[9]

Unfortunately, pay-to-stay agreements, rapid-reorganization bonuses, and the Skeel proposals all contain significant flaws.[10] Pay-to-stay agreements may enable the debtor to retain key managerial personnel, but they do nothing to ensure that a manager will attempt to maximize value. Rapid-reorganization bonuses incentivize a speedy reorganization, not a value-maximizing one. Granting a manager a percentage of liquidation proceeds works well if liquidation is the obvious choice. When liquidation is not the efficient option, however, the prospect of a percentage of the asset return in liquidation may encourage a manager to push for liquidation even when reorganization would create more value. Finally, granting stock in the reorganized company skews managerial incentives in a number of ways. First, it may encourage a manager to prefer reorganization when liquidation is a more efficient option. Second, owning stock in the reorganized company means that a manager has an incentive to ensure that the equity of the reorganized company is of the utmost value. This encourages the manager to propose reorganization plans wherein the reorganized company has little or no debt, even if the company would have a higher total valuation with some debt in its capital structure.[11]

LAW., May 29, 2006, http://www.law.com/jsp/tx/PubArticleTX.jsp?id=1150275918997 (synthesizing the terms of 11 U.S.C.A. § 503(c)(1)(A)-(C)).

[7] Skeel, *supra* note 4, at 948.

[8] *Id.*

[9] *Id.*

[10] Many bankrupt companies are currently run by "turnaround managers" who specialize in resuscitating distressed companies. *See, e.g.*, Steven F. Hodkinson, *Credibility: The Real Key to Turnaround Success*, AM. BANKR. INST. J., Oct. 2006, at 36 (describing some practices of a successful turnaround manager). If the turnaround managers are hired by individuals with an interest in maximizing the value of the firm as a whole, rather than the claim of one class, and the turnaround managers are repeat players, then failures in compensation will be mitigated by the turnaround manager's desire for a good reputation.

[11] If the Modigliani-Miller theorem applies, then this concern is not relevant. Modern corporate finance has identified several reasons why the theorem does not

All of these problems stem (at least in part) from a fundamental difficulty of granting incentive compensation in bankruptcy as compared to incentive compensation in an ordinary solvent firm. In an ordinary solvent firm, a manager's fiduciary duty is associated with the residual claimants—the equity holders.[12] As a result, equity-based incentive compensation plans, such as stock options, are relatively easy to adopt.[13] By granting equity to the manager, incentive compensation aligns managerial incentives with those of the equity residual claimants—when the residual claimants benefit, so does the manager. The manager's pecuniary incentives accord with her fiduciary duties. In bankruptcy, by contrast, the residual claimants (and the manager's fiduciary responsibilities[14]) are harder to identify. Most frequently, the residual claimants, and those owed fiduciary obligations, are unsecured creditors.[15] In response, the executive compensation proposals

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apply in most cases, including tax considerations and the mitigation of principal-agent problems. The wide variety of capital structures witnessed among public corporations suggests that capital structure matters, in spite of the Modigliani-Miller theorem. *See* MARK GRINBLATT & SHERIDAN TITMAN, FINANCIAL MARKETS AND CORPORATE STRATEGY 498-99 (2d ed. 2002).

[12] Most suits for breach of fiduciary duty are brought by equity shareholders. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 863-64 (Del. 1985) (concerning a class action suit brought by shareholders against corporate directors for breach of the duty of care).

[13] Equity-based compensation plans have themselves come under attack over the last few years. This is because the plans seldom provide the incentives for which they are intended. Instead, they often serve as a vehicle for managers to extract rents from their corporation. *See* Lucian Ayre Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 753 (2002) (arguing that both the process by which executive compensation plans are adopted and the empirical evidence regarding such plans support the claim that managers have significant influence over the substance of their compensation).

[14] To be precise, fiduciary responsibilities are owed to the corporation rather than to a group of claimants. In reality, fiduciary duties will typically be associated with a group of claimants against the firm because of the difficulty of determining fiduciary duties to an abstract entity such as the corporation.

[15] Courts have implicitly recognized that creditors are common residual claimants by maintaining that corporate officers of insolvent companies have fiduciary duties to creditors. For examples of such judicial recognitions, see *Unsecured Creditors Committee of Debtor STN Enterprises v. Noyes (In re STN Enterprises)*, 779 F.2d 901, 904 (2d Cir. 1985); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982); *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); *Thomson Kernaghan & Co. v. Global Intellicom, Inc.*, Nos. 90 Civ. 3005 (DLC), 99 Civ. 3015 (DLC), 2000 WL 640653, at *12 (S.D.N.Y. May 17, 2000); *Official Committee of Unsecured Creditors of Buckhead America Corp. v. Reliance Capital Group, Inc. (In re Buckhead America Corp.)*, 178 B.R. 956, 968 (D. Del. 1994); *Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 208 B.R. 288, 300 (Bankr. D. Mass. 1997) (interpreting Delaware law); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-90

described above use some proxy for residual claimants when awarding compensation. This process is subject to errors. For example, granting the manager equity in the reorganized firm works well if the residual claimants in bankruptcy also will hold equity in the reorganized firm. If, however, some of the residual claimants in bankruptcy hold debt in the reorganized entity, then there may be a conflict of interest between the manager and the residual claimants.[16]

To remedy these defects and reorient the scholarly debate in bankruptcy toward the problem of executive compensation rather than focusing almost exclusively on other means of corporate governance, this Article proposes a novel form of managerial incentive compensation for publicly traded corporations in bankruptcy. The unsecured creditors' committee should be granted a new (conditional) right—the right to grant the manager a percentage of the unsecured debt (a "vertical strip" of unsecured debt) currently held by the creditors of the firm.[17] This right would be subject to several conditions, as described below. Because unsecured creditors are the most common residual claimants in bankruptcy,[18] this right would enable the residual claimants to align the incentives of the manager with their own. When the value of a bankrupt firm rises, it is typically the unsecured creditors who obtain the greatest benefit because they are the most common residual claimants. Granting a manager debt in the bankrupt firm allows the creditors to share these gains with the manager and ensures that the manager has the appropriate incentive to pursue these gains.

(Del. Ch. 1992); *Crédit Lyonnais Bank Nederland, N.V. v. Pathé Commications Corp.*, No. 12150, 1991 WL 277613, at *33 (Del. Ch. Dec. 30, 1991).

[16] Even when unsecured creditors hold debt in the reorganized firm, the debt that they receive in the reorganized firm is often worth less than the face value of the debt that these creditors held in the bankrupt firm, indicating that the unsecured creditors are the residual claimants in spite of the fact that they never hold equity.

[17] Throughout this Article, I will refer to this proposal as "debt compensation."

[18] In a recent empirical survey of bankruptcies, unsecured creditors proved to be the residual claimants in over half of the Chapter 11 bankruptcies. *See* Arturo Bris et al., *The Costs of Bankruptcy: Chapter 7 Cash Auctions vs. Chapter 11 Bargaining*, at tbl.8 (EFA 2004 Maastricht Meetings, Paper No. 5155, 2004) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556930 (summarizing findings from a sample of cases from the Federal Bankruptcy Courts of Arizona and the Southern District of New York). Equity holders (who share many similarities with unsecured creditors in bankruptcy and can also join the debt compensation scheme as described below) were the residual claimants in another quarter of Chapter 11 cases. *Id.* Thus, secured creditors (who are not eligible for the debt compensation scheme) obtain full recovery in a large majority of Chapter 11 cases.

Granting the manager a percentage of unsecured debt solves many of the inefficient incentive problems generated by the plans described above. If a rapid reorganization increases the total value of the firm and thereby the total recovery for unsecured debt, then a manager receiving a percentage of this debt will have a greater incentive to reorganize rapidly because a rapid reorganization increases the value of the manager's own debt. If a rapid reorganization destroys value, however, then the manager will avoid this choice, unlike a manager receiving a rapid-reorganization bonus. Similarly, a manager receiving a percentage of unsecured debt has no incentive to inefficiently favor reorganization or liquidation. If liquidation is the most efficient choice, then this will be reflected in an increase in the value of unsecured debt. Because the manager receives a percentage of this increase in value, the manager will have an incentive to choose efficient liquidation. Finally, debt compensation protects against the tendency of the manager to favor equity in bankruptcy. When the manager of a bankrupt company is the same person as the pre-bankruptcy manager, that manager will have many ties to equity, which used to control the firm. For example, the manager may have received grants of stock or stock options before the company became bankrupt, giving the manager a direct incentive to favor equity. Debt compensation protects against the manager's inclination to favor equity by giving the manager a direct financial incentive in the performance of debt. If the manager favors equity and in the process destroys value, then the manager receiving debt compensation will experience a financial penalty, as the value of unsecured debt will diminish.

Enabling the creditors' committee to grant the manager debt is no panacea. A debt compensation plan must address several concerns. First, secured creditors may be harmed by the proposal. Debt compensation gives the manager an incentive to raise the value of unsecured debt, possibly at the expense of secured debt. The manager will have an incentive to take potentially value-destroying risks because the upside risk is enjoyed by unsecured creditors (and shared by the manager) while the downside risk is borne by the secured creditors (and not shared by the manager).[19] When the value of the firm's assets is near the value of the secured debt claims alone, for example,

[19] This problem resembles the "asset substitution problem" that is commonly discussed in corporate law and finance, in which the interests of debt and equity are at odds. *See* GRINBLATT & TITMAN, *supra* note 11, at 569 (arguing that debt provides an incentive for firms to take on unnecessary risk because increasing a firm's risk transfers wealth from the firm's debt holders to its equity holders).

the likelihood that secured creditors will be hurt by value-destroying managerial risk taking is enhanced. Similarly, an extraordinarily high award of unsecured debt gives the manager greater incentive to favor unsecured creditors at the expense of those who are secured. To mitigate these problems, the bankruptcy judge should deny the unsecured creditors' committee's debt compensation grant under these circumstances.[20]

Second, debt compensation must be structured to avoid conflicts of interest among unsecured creditors. For example, if the manager owns 1% of some unsecured debt but no percentage of other claims, the manager would have an incentive to favor some classes of unsecured creditors over others when forming a plan of reorganization. To prevent this, the creditors' committee's decision on the size of the debt compensation must bind all unsecured creditors. Such a vertical strip approach means that the manager potentially holds unsecured debt with many different priority levels, but a constant percentage of each type of debt. This creates a level playing field among unsecured creditors. While some unsecured creditors may object to the loss of some percentage of their claims, this decision would be no different than many other actions taken by the creditors' committee that have the potential to diminish the value of some creditors' claims. As a result, the binding nature of the creditors' committee's decision should not be problematic.

Alternatively, the proposal could be modified to allow the most senior unsecured creditors to opt out of awarding debt compensation. If senior unsecured creditors are extremely confident that they will receive their money in any case, then they may see no need to spend money compensating the manager. An opt-out provision for unsecured creditors would reduce the cost of the proposal. While the opt-out option may provide incentives for a manager to favor junior unsecured creditors over senior unsecured creditors, senior unsecured creditors will have the ability to weigh this concern when determining whether or not to opt out.

Third, equity may also be concerned about debt compensation, since debt compensation gives the manager the incentive to favor unsecured creditors over equity. In some cases, this gives the manager the incentive to be overly cautious. To prevent this problem, equity

[20] Alternatively, judges could approve an unsecured debt compensation structure on the condition that the unsecured creditors make good on any loss to the secured creditors.

should be entitled to match the percentage compensation award given by the creditors' committee. This will ensure that equity is not disfavored with respect to unsecured debt by the manager.

Finally, the cost of the proposal may be a concern. Debt compensation may increase the salaries of managers in bankruptcy. Because the creditors' committee chooses whether or not to award debt compensation, however, the cost of debt compensation should not be a major concern. Unlike ordinary boards, the manager is unlikely to control a creditors' committee. If the committee chooses to award debt compensation, the decision provides strong evidence that the committee believes that debt compensation is worth the cost. If the committee does not believe so, then it will not award a debt compensation grant.

Thus, a creditors' committee's right to grant debt compensation offers a new means to improve managerial performance in bankruptcy. In spite of a number of concerns about the proposal, it should be viable if adopted as described here. Moreover, courts can adopt this approach conservatively at first by rejecting aggressive compensation proposals. Then, as judges grow more familiar with the debt compensation procedure, the size and prevalence of the debt compensation awards and their positive effects on managerial performance in bankruptcy can grow.

This Article proceeds as follows: Part I outlines an example that will be used to illustrate many of the points developed in this paper. Part II examines existing managerial compensation schemes in bankruptcy and discusses their flaws in greater detail. Part III details the debt compensation proposal and examines how the proposal addresses many of the flaws of the existing compensation schemes described in Part II. Part IV discusses possible objections to the debt compensation proposal and details how the proposals can be modified to account for these concerns.

I. A HYPOTHETICAL FIRM IN BANKRUPTCY

Many of the proposals and critiques in this Article are best developed through an example. In order to maintain continuity, this Part outlines the basic framework of the example. As the Article continues, many aspects of the example will be modified to illustrate particular points.

Suppose that a firm ("Firm") declares bankruptcy. Suppose further that:

Assumption 1: Firm has three classes of claimants: secured claimants, who are owed $10 million; unsecured creditors (all of equal priority), who are owed $50 million;[21] and equity claimants.

Assumption 2: If Firm liquidates, it will raise $20 million.

Assumption 3: The value of Firm if it reorganizes is more uncertain than the liquidation value and depends upon the actions of the manager ("Manager").[22] The exact relationship between managerial effort and value will be developed in greater detail in later sections of this Article.

Assumption 4: Manager generally acts to maximize salary. Manager tends to favor equity because Manager owns equity (for example, restricted stock grants and stock options, as well as ordinary stock) and has a longstanding fiduciary relationship with the stockholders.

II. EXISTING MANAGERIAL COMPENSATION ARRANGEMENTS IN BANKRUPTCY

Managers have two jobs in bankruptcy. First, they run the corporation, just as ordinary managers do. In addition, they form a plan of reorganization or liquidation.[23] This typically involves a fundamental reshuffling of the firm's capital structure, as well as new agreements with other firm stakeholders such as employees and lessors. The manager's role is therefore particularly important in bankruptcy, and has critical implications for all claimants on the bankrupt firm.

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[21] The assumption that there is only one class of unsecured creditors is not farfetched. Section 1122(a) of the Bankruptcy Code provides that all "substantially similar" creditors should be placed in the same class of creditors. 11 U.S.C. § 1122(a) (2000). Because all unsecured claimants have the same rights outside of bankruptcy, there is a reasonable argument that all unsecured claimants should be in the same class. *See* Granada Wines, Inc. v. New Eng. Teamsters & Trucking Indus. Pension Fund, 748 F.2d 42, 46 (1st Cir. 1984) (recognizing that "[s]eparate classifications for unsecured creditors are only justified 'where the legal character of their claims is such as to accord them a status different from other unsecured creditors'" (quoting *In re* L.A. Land & Invs., Ltd., 282 F. Supp. 448, 454 (D. Haw. 1968), *aff'd*, 447 F.2d 1366 (9th Cir. 1971))); BAIRD, *supra* note 1, at 208 (arguing that trade and deficiency claims should be in the same class since they are both unsecured claims and neither enjoys priority over the other).

[22] Throughout this Article, I will use the singular term "manager." Management, of course, often consists of several individuals. All of the points made in this Article, however, apply equally well to the case of a management team as they do to a single manager.

[23] *See* 11 U.S.C. § 1121(b) (granting the debtor an exclusive right to develop a plan of reorganization for 120 days).

Chapter 11 of the 1978 Bankruptcy Code[24] grants considerable powers to the manager of a firm declaring bankruptcy. For example, Chapter 11 authorizes managers to operate the firm as "debtors-in-possession" and grants managers a window during which they have the exclusive right to propose a plan of reorganization.[25] The Bankruptcy Code thereby combines considerable managerial powers with limited managerial controls—a recipe for trouble. It should not be surprising, then, that managerial performance in the early days of the Bankruptcy Code was poor. As Professor Skeel stated, "[m]anagers were playing with creditors' money."[26]

Luckily, the bankruptcy system has confronted some of these problems. In his survey article, Professor Skeel describes several corporate governance techniques currently in use as well as a number of new proposals.[27] Some of these methods, such as debtor-in-possession financing,[28] control the manager's behavior indirectly, while others, such as rapid-reorganization bonuses,[29] give the manager direct incentives to behave in certain ways. While all of these methods constitute important improvements with respect to the early Chapter 11 practices, they all retain some critical flaws.

A. *Debtor-in-Possession Financing*

Debtor-in-possession (DIP) financing allows some creditors to obtain considerable leverage over a debtor-in-possession. DIP financing works as follows: Under § 364 of the Bankruptcy Code, creditors who provide financing to debtors in bankruptcy enjoy many enhanced rights (subject to court approval), such as priority with respect to all secured and unsecured loans and administrative expenses.[30] When a debtor needs cash to continue operations, a prospective DIP lender can make numerous demands of the debtor. These demands may include a change in management or seats on the debtor's board of di-

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[24] *Id.* §§ 1101-1174.

[25] *Id.* § 1121(b). For a detailed discussion of corporate governance in Chapter 11, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 160-83, 212-37 (2001).

[26] Skeel, *supra* note 4, at 920.

[27] *See id.* at 919-20 (outlining Skeel's discussion of corporate governance in the context of bankruptcy).

[28] *Id.* at 923-26 (outlining the structure of DIP financing).

[29] *Id.* at 928 (describing the growing practice of giving managers bonuses for quickly selling a debtor's assets).

[30] 11 U.S.C. § 364(c)(1), (d) (2000).

rectors.[31] Thus, if a manager will need DIP financing, her behavior is constrained by the prospect that the DIP lender will demand a change in management if the manager's performance is weak.

DIP financing thus provides a useful check on managerial behavior. However, it does not come close to providing a comprehensive solution to the problem of managerial performance in bankruptcy.[32] First, DIP financing comes with its own flaws, such as the possibility of overinvestment.[33] Second, not all debtors need DIP financing. When the debtor does not require cash to operate,[34] a manager is unlikely to submit to the requirements of DIP lenders. Third, DIP lenders are not ideal monitors of managerial performance. Because DIP lenders enjoy enhanced priority, they may not be particularly interested in the firm's performance, as they are guaranteed repayment in almost all eventualities. Even if the DIP lender is not assured of repayment, it will be risk averse because, as a super-secured creditor, it only risks nonpayment if the firm's assets fall in value.[35] In either case, the DIP lender is unlikely to pressure the manager to make value-maximizing decisions because the DIP lender is not the residual claimant. This tendency will be exacerbated when the DIP lender is already a large creditor of the bankrupt firm.[36] If this is the case, then the DIP lender

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[31] Skeel, *supra* note 4, at 931.

[32] Large DIP lenders include J.P. Morgan and GE Capital, which were both involved in making multibillion-dollar DIP loans to WorldCom and Kmart. Daniel Gross, *WorldCom Is Bankrupt; So How Did It Get a $2 Billion Loan?*, SLATE, July 24, 2002, http://www.slate.com/id/2068443.

[33] The knowledge that DIP financing can be obtained after all assets have already been secured can lead a firm to overinvest in current projects, secure in the knowledge that if a profitable future opportunity arises, the firm will be able to find financing. For a general discussion of DIP financing, see George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993).

[34] Debtors in bankruptcy enjoy a stay from loan repayments. Any debtor with positive operating cash flow or significant cash reserves will therefore be able to operate in bankruptcy without the need for DIP lending. Of course, companies with positive cash flow or large cash reserves are unlikely to declare bankruptcy. Examples of companies that have declared bankruptcy with positive cash flows and cash reserves include companies facing large tort liabilities, such as Johns Manville (asbestos liability) and Dow Corning (breast implant liability). For a discussion of these cases, see Yair Listokin & Kenneth Ayotte, *Protecting Future Claimants in Mass Tort Bankruptcies*, 98 NW. U. L. REV. 1435, 1443-51, 1490 (2004); Mark J. Roe, *Bankruptcy and Mass Tort*, 84 COLUM. L. REV. 846, 858 nn.33-34, 867 n.58, 894 n.146, 915 n.225 (1984).

[35] For a more detailed discussion of "the troublesome incentives of a DIP lender who faces at least some downside risk," see Skeel, *supra* note 4, at 935-39.

[36] For a case in which the unsecured creditors' committee objected to the terms of a DIP loan, see *Official Committee of Unsecured Creditors of New World Pasta Co. v. New World Pasta Co.*, 322 B.R. 560, 564 (M.D. Pa. 2005).

may favor actions that maximize the value of its other loans, rather than actions that maximize the value of the firm as a whole. Finally, even if the DIP lender replaces the management, someone must run the company. If incentives for the new managers are not appropriate, then DIP financing has altered, rather than eliminated, the corporate governance problem for firms in bankruptcy.

B. *Managerial Compensation*

Managerial "pay-for-performance" plans offer the potential for a more direct and comprehensive solution to the managerial incentive problem in bankruptcy. If a manager's pay can be aligned with the value she creates or destroys in bankruptcy, then the manager will have a greater incentive to maximize firm value. Rather than depending on managerial goodwill to ensure proper behavior, incentive compensation plans rely on managerial self-interest to stimulate good behavior. Unfortunately, designing pay-for-performance plans in bankruptcy is tricky. All of the existing and proposed plans suffer from serious flaws, suggesting an acute need for new proposals in this area.

1. Pay-To-Stay Bonuses

Professor Skeel reviews several pay-for-performance plans. The simplest of these is the "pay-to-stay" bonus.[37] In order to prevent talented personnel from leaving a troubled debtor, some companies offer bonuses to key managers who remain with the company through bankruptcy. In addition to the troubling perceptions generated by granting bonuses to the manager of a newly bankrupt company, pay-to-stay bonuses give a manager no incentives for good performance. If Manager of Firm received a pay-to-stay bonus, for example, it would have no effect on Manager's incentives to choose liquidation (Assumption 2) as opposed to reorganization (Assumption 3), nor would it have any impact on Manager's incentives to choose the best reorganization plan under Assumption 3. Debtor firms would be better served by using the money currently devoted to pay-to-stay bonuses on pay-for-performance plans. These plans give managers an incentive to

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[37] *See* Skeel, *supra* note 4, at 926-28 ("Despite their reservations . . . creditors increasingly have concluded that they are better off paying to keep the debtor's existing managers in place.").

stay while also creating incentives for value-maximizing managerial behavior.

2. Rapid-Reorganization Bonuses

The most widely used pay-for-performance measure at present is the rapid-reorganization bonus.[38] Under this plan, a manager's compensation is tied to the speed of reorganization: the faster the reorganization, the greater the manager's compensation.[39] When firm value is closely correlated with reorganization speed, a rapid-reorganization bonus properly aligns the manager's incentives with those of the residual claimants, who benefit most from a rapid reorganization. In many cases, however, faster reorganizations do not maximize value. If a firm's capital structure is reorganized hastily and ineffectually, for example, then the firm may experience difficulties after it emerges from a rapid reorganization, ultimately hurting the value recouped by creditors. Moreover, the rapid-reorganization bonus neglects any incentive for good management during the reorganization of the company. With no reward for effectively operating the company, a manager will focus primarily on a plan of reorganization. The firm's operations may suffer accordingly.

The example outlined in Part I provides an illustration of the dangers of rapid reorganization. Suppose that Manager receives a rapid-reorganization bonus, but is otherwise compensated by a flat salary. Assumption 3 of this example adds that the reorganization value of Firm depends upon Manager's efforts. Suppose further that Manager can choose whether or not to hire consultants who will facilitate the reorganization process, that the consultants cost $10 million in fees, and that by speeding the reorganization process, they raise the value of Firm by $5 million. Efficiency dictates that Manager should not hire the consultants because the consultants cost more than the value they provide. With a rapid-reorganization bonus, however, Manager would choose to hire the consultants. Manager's salary goes up when reorganization is speedier, but is otherwise independent of Firm's value. As a result, our self-interested Manager would choose to hire the costly consultants.

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[38] *See id.* at 928 (noting that creditors "in recent cases" have insisted on linking manager compensation to the firm's "progress under Chapter 11," and that the easiest way to measure this progress is by speed of reorganization).

[39] The Enron managerial pay proposal included bonuses for selling assets quickly. Frank Ahrens, *Enron Files for New Bonuses, Severance*, WASH. POST, Mar. 30, 2002, at D13.

3. Percentage-of-Assets Compensation Plans

Professor Skeel recognizes the need for different measures that "more closely link managers' effectiveness to their bankruptcy pay," and discusses some possibilities for meeting this demand.[40] He asserts that the best measure of managerial performance is to base managerial compensation on the overall value of the debtor's assets at the conclusion of bankruptcy and then recommends this approach for bankrupt firms that undergo liquidation.[41]

a. *Skewed Incentives*

The "percentage-of-assets" approach, however, fails to offer a general solution to the managerial compensation problem in bankruptcy. As Professor Skeel notes, the percentage-of-assets approach can be problematic in Chapter 11 reorganizations because it is difficult to obtain an accurate valuation of the debtor's assets at the end of bankruptcy.[42]

The percentage-of-assets approach suffers from some other flaws not mentioned by Professor Skeel. For example, it encourages managers to unduly favor liquidation over reorganization. Returning to the example developed in Part I, suppose that Manager's compensation scheme calls for her to receive 1% of Firm's assets should Firm be liquidated and that Manager would receive a salary of $80,000 in the event of a reorganization. Suppose also that Firm will be worth $25 million after reorganization. Reorganization thus realizes more value than liquidation. Manager, however, prefers liquidation since she would receive $200,000[43] in compensation, which is greater than the $80,000 salary she would receive after reorganization. Because of this problem, the percentage-of-assets approach can only be used

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[40] Skeel, *supra* note 4, at 948-49.

[41] *Id.* at 948.

[42] *Id.* In this respect, the percentage-of-assets approach differs from pay-for-performance schemes (such as stock options) outside of bankruptcy, which are easy to value because they are granted in a form for which the market provides a valuation. The debt compensation proposal described in the next Section of this Article helps obtain the tight link between managerial performance and compensation that Skeel seeks without the need to directly value the debtor's assets at the end of bankruptcy.

[43] Recall that in liquidation, Manager would receive 1% of $20 million.

when liquidation is unquestionably the preferred option, severely limiting this approach's value.[44]

b. *Low-Powered Incentives*

The percentage-of-assets approach also specifies a very "low-powered" and expensive pay-for-performance plan.[45] To see this, modify Assumption 2 to allow Manager's effort to impact Firm's liquidation value. If Manager performs poorly, Firm is worth $10 million in liquidation, but if Manager performs well, Firm is worth $12 million in liquidation. In these circumstances, granting Manager a percentage of the first $10 million of Firm is wasteful. Firm will be worth at least $10 million no matter what Manager does, so granting Manager a percentage of the first $10 million (assuming Manager still gets 1% of the value of the firm) costs money while generating no incentives for improved performance. Rather than granting a simple percentage of Firm's assets, a better pay-for-performance plan would only grant Manager a percentage of the value of the debtor's assets in excess of $10 million. Under this plan, Manager only receives a bonus if her performance generates value; no money is wasted on paying Manager unnecessarily.

The percentage-of-assets plan also fails to specify how the costs of CEO compensation should be shared among the firm's various creditors. The secured creditors of Firm would dislike the percentage-of-assets approach because their claims are only $10 million (Assumption 1) and Firm is guaranteed to be worth that much regardless of the quality of Manager's performance during liquidation. Thus, Firm's secured creditors would view the percentage-of-assets approach as wasteful. Unsecured creditors, by contrast, would favor the percentage-of-assets approach because it incentivizes Manager to create additional value and thus increase the amount recovered by this class of creditors. The percentage-of-assets approach must develop some means of allocating costs between these two classes of creditors. For all of these reasons, the percentage-of-assets approach, while intriguing, does not

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[44] This example is admittedly contrived. Nevertheless, the fact that it is so easy to develop an example wherein the percentage-of-assets approach fails suggests that the approach has very limited applicability.

[45] Low-powered incentives occur when a manager does not reap a large percentage of the value that her efforts create. For a discussion of low-powered incentives in managerial compensation and leveraged buyouts, see Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

offer a promising pay-for-performance package for managers of bankrupt firms.

4. Percentage of Equity Compensation Plans

Professor Skeel next suggests that managers receive a portion of the reorganized entity's stock.[46] This proposal appears to give managers strong incentives to operate the debtor efficiently. The better a firm's operations perform in bankruptcy, the greater the value of the reorganized entity, and therefore the greater the value of a manager's portion of equity. Nevertheless, Professor Skeel's proposal includes two flaws: it would both encourage an inefficient capital structure after reorganization and tempt the manager to understate the value of the firm's equity in order to secure approval of the plan.

a. *Inefficient Capital Structure*

Unfortunately, granting a manager a portion of the equity in a reorganized company provides the manager with poor incentives to restructure the company effectively. Rather than attempting to formulate a reorganization plan and financial structure that maximizes value for the creditors of the bankrupt firm, the manager has an incentive to maximize the value of the equity in the reorganized entity. Thus, the manager's incentives may conflict with the creditors' goals. For example, the manager has an incentive to eliminate as much debt as possible in reorganization.[47] The less debt in the bankrupt company assumed by the reorganized company, the greater the value of the reorganized company's equity. A manager may even threaten to destroy value to induce creditors to cancel more of their claims against the reorganized debtor—clearly inefficient behavior. Relatedly, a manager promised a certain percentage of the equity in a reorganized corporation has no incentive to create a financial structure that maximizes the value of the reorganized entity. Instead, the manager would prefer an all-equity capital structure with no debt to dilute the value of her equity rights. This behavior may be inefficient. Researchers in corporate finance have identified many advantages to debt as a means of mitigating a wide array of agency problems.[48] If

[46] Skeel, *supra* note 4, at 948.

[47] *Id.*

[48] For an overview of some of debt's many advantages within a firm's capital structure, see OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 95-155 (1995). These advantages include (1) tax considerations (interest payments to creditors are

the reorganized firm holds too little debt, agency problems may prove formidable, thereby reducing the total value of the debtor's assets.

The dangers of equity compensation can be highlighted in our example. Suppose that Manager gets 5% of equity in the reorganized Firm. Further suppose that, by mitigating agency problems, a capital structure that has a debt-equity ratio of 1 to 1 makes the reorganized Firm worth $40 million ($20 million in debt and $20 million in equity), while an all-equity reorganized Firm would be worth $30 million ($0 in debt and $30 million in equity). In this context, efficiency dictates that Manager should choose the debt-equity ratio of 1 to 1 because it realizes $10 million more in value. Manager would choose an all-equity capital structure, however, because Manager's return is higher under this structure; 5% of the $30 million in equity of the all-equity reorganized Firm is greater than 5% of the $20 million in equity of the more evenly balanced Firm, even though Firm is more valuable with a debt-equity ratio of 1 to 1.

b. *Skewed Incentives for Getting a Plan of Reorganization Confirmed*

To be confirmed by a bankruptcy court, a plan of reorganization must satisfy § 1123(a)(4), which requires that a plan "provide the same treatment for each claim or interest of a particular class."[49] Equity compensation plans, however, give managers incentives to understate the value of equity in order to get a plan confirmed that maxi-

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deductible from corporate tax obligations, while dividends are taxed at both the corporate and personal levels), *see* Franco Modigliani & Merton H. Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 AM. ECON. REV. 433, 434 (1963) (demonstrating that the tax advantages of debt financing are significant); (2) the value of preventing a manager from squandering free cash flows by requiring the manager to pay out cash regularly in the form of interest, *see* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 323-26 (1976) (discussing the increases in efficiency that can be won through investor monitoring of managers); and (3) the avoidance of the lemon problem (investors are more wary of firms issuing equity than firms issuing debt because investors suspect that any firm that issues additional equity must be pessimistic about its future prospects), *see* Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187, 207-09 (1984) (concluding that, empirically, issuing debt rather than equity is better for shareholders). Disadvantages of debt include increasing the risk of a costly bankruptcy reorganization or investment-skewing financial distress. *See, e.g.*, Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443, 1443-46 (1998) (noting the correlation between highly leveraged transactions and debt default, that together lead to bankruptcy or financial distress).

[49] 11 U.S.C. § 1123(a)(4) (2000).

mizes the value of their stake in the reorganized company's equity. Because managers often have the best information about the company's true value, such skewed incentives may wreak havoc with courts' ability to ensure that § 1123(a)(4) is observed.[50]

Note that even though there is only one class of unsecured creditors of Firm, some of these creditors might prefer equity in the reorganized entity while others prefer debt. Furthermore, Manager will have the best estimate of the true value of Firm. Other parties must either rely on her estimates or expend considerable sums in developing their own estimates.

Under these conditions, Manager might have a strong incentive to understate Firm's value for two reasons. First, as the perceived value of equity decreases, so does Manager's perceived compensation. Manager will then have an incentive to underestimate the value of Firm's equity in order to hide the true size of her compensation, thus avoiding any public outrage over the size of her salary. Second, if Manager continues in her role after reorganization, then her future employers would be the shareholders in the reorganized firm. Manager might want to gain favor with her future employers by underestimating the value of their equity, thereby leading to windfall returns for those taking equity compared with those taking debt. In total, these inefficient incentives may cause significant additional complications in the already arduous process of getting different creditors to agree to different securities in the context of a reorganization plan.

Thus, while pay-for-performance managerial compensation plans in bankruptcy offer the promise of improved managerial performance, existing practice and proposals suffer from several flaws. Professor Skeel explicitly notes the value of "continued experimentation" in this area.[51] Along these lines, the next Part proposes a new plan, unsecured debt compensation for managers, that addresses many of the flaws discussed in this Part while preserving the advantages of pay-for-performance.

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[50] For an analysis of the difficulties plaguing the valuation process in bankruptcy, see Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV. 403, 414-38.

[51] Skeel, *supra* note 4, at 949.

C. *Enron as an Example of the Deficiencies of Current Methods of CEO Compensation in Bankruptcy*

The Enron bankruptcy highlights many of the dangers of managerial compensation in bankruptcy described above. Once Enron declared bankruptcy, it hired a new manager, Stephen Cooper, head of the turnaround firms[52] Kroll Zolfo Cooper, LLC and Stephen Forbes Cooper, LLC.[53] Cooper was granted an annual salary of $1.32 million and his firm was guaranteed a bonus of at least $5 million if Enron avoided liquidation.[54] The exact amount of the bonus was ultimately subject to the bankruptcy court's approval at the conclusion of the case.[55] Note the dangers inherent in these terms: Cooper's salary did nothing to enhance his incentives to maximize the value received by the firm's creditors, and his bonus gave him an incentive to avoid liquidation. Obviously, if liquidation was the efficient option, then this incentive was inefficient, but even if liquidation was inefficient, Cooper's incentives were still misplaced. Once Cooper succeeded in avoiding liquidation, he had few direct incentives to take further steps to maximize the value of Enron's assets.

These deficiencies in managerial compensation undermined confidence in the Enron bankruptcy. Cooper directed Enron to hire many employees of his own primary employer, Kroll Zolfo Cooper. By the end of the bankruptcy, Enron had paid Kroll Zolfo Cooper over $63 million in fees.[56] As a principal in the turnaround firm, Cooper clearly benefited from the fees earned by Kroll Zolfo Cooper. It is less clear, however, that these fees benefited Enron. Cooper's contract provided no disincentive to incur such fees. So long as the fees helped avoid a liquidation and could be explained to the bankruptcy court as reasonable, Cooper had every incentive to hire his colleagues, even if these hires did not maximize Enron's value. Similarly, Cooper

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[52] A "turnaround firm" is a firm that specializes in improving the fortunes of bankrupt or distressed companies.

[53] Floyd Norris & David Barboza, *Lay Sold Shares for $100 Million*, N.Y. TIMES, Feb. 16, 2002, at A1; *U.S. Says It Found Problems in Enron Bankruptcy Billing*, N.Y. TIMES, March 28, 2006, at C3. Note that the purpose of this Section is not to suggest that Mr. Cooper behaved improperly, but rather that many of Enron's bankruptcy expenditures may or may not have been efficient, and that the executive compensation structure did nothing to encourage efficient expenditures.

[54] *Id.*

[55] *See* Jonathan Stempel, *Enron CEO's Firm Seeks $25 Mln "Success Fee"*, REUTERS, Sept. 3, 2004 (stating that Kroll Zolfo Cooper LLC "asked a bankruptcy judge for a . . . 'success fee,'" clearly implying that the fee was subject to court approval).

[56] *Id.*

had no reason to reduce the size of Enron's legal bills. High legal costs may have reduced the probability of liquidation and thereby enhanced Cooper's expected bonus, even if the legal fees did not ultimately raise the creditors' return. In light of these factors, the questions surrounding the Enron bankruptcy—with fees totaling approximately $1 billion, the "priciest on record"[57]—persist. These fees may have created even more than $1 billion of value for Enron. The skewed incentives created by Cooper's employment contract, however, ensure that suspicion about the fees will linger.[58]

The difficulty of providing performance incentives in bankruptcy is further exemplified by Kroll Zolfo Cooper's request for bankruptcy court authorization of a $25 million "success fee" at the conclusion of Enron's bankruptcy.[59] In spite of the high fees billed to Enron by Kroll Zolfo Cooper employees, the firm claimed that it was entitled to the "success fee" because it had "produced extraordinary results for the bankruptcy estate."[60] Kroll Zolfo Cooper may well have been telling the truth. The unclear criteria for granting pay-for-performance compensation in bankruptcy, however, prevented creditors and the bankruptcy court from having confidence that the success fee was a bona fide pay-for-performance measure rather than a windfall created by the fact that the head of Kroll Zolfo Cooper was also serving as the head of Enron. Thus, whatever one thinks of Stephen Cooper's performance as Enron's manager, his compensation contract clearly highlights the need for more effective pay-for-performance designs in bankruptcy.

III. DEBT COMPENSATION FOR MANAGERS

A. *Unsecured Creditors and Chapter 11 Bankruptcies*

Before presenting the debt compensation proposal, it is crucial to establish some context for the proposal's place within a Chapter 11 bankruptcy.[61] With limited exceptions,[62] the Bankruptcy Code pro-

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[57] Eric Berger, *Enron's Legal Fees Priciest on Record*, HOUS. CHRON., Oct. 19, 2003, at 1A.

[58] *See id.* (quoting many sources suggesting that Enron's bankruptcy fees were unnecessarily high).

[59] Stempel, *supra* note 55.

[60] *Id.*

[61] Most large insolvencies occur in Chapter 11. *See, e.g.*, Bris et al., *supra* note 18, at tbls.1 & 2 (showing more corporate bankruptcies proceeding within Chapter 11 than Chapter 7 and presenting data to show that the assets of Chapter 11 companies

vides that all unsecured creditors enjoy similar rights in bankruptcy. The "adequate protection" clauses of §§ 363 and 364 subordinate unsecured creditors to secured creditors.[63] Notwithstanding the special treatment of secured creditors, several provisions of the Code require that similarly situated unsecured creditors receive similar treatment in any plan of reorganization or liquidation of a bankrupt company.[64] In other words, similarly situated creditors share pro rata.[65] The "fair and equitable" provisions, however, do not simply provide that all unsecured creditors get the same return on their money. Some unsecured creditors may be contractually senior to other unsecured creditors. If this is the case, then the "absolute priority rule" requires that the senior unsecured creditors receive full payment before the junior unsecured creditors receive any payments.[66]

When a company files for Chapter 11 bankruptcy, a committee ("the committee") is formed to represent the interests of unsecured creditors in the bankruptcy.[67] The Bankruptcy Code further stipulates that the committee consist of representatives from the seven largest unsecured creditors.[68] Alternatively, the Code allows the committee to be composed of other willing creditors, so long as the creditors serving on the committee are "representative of the different kinds of

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are much greater than companies in Chapter 7). Note, however, that committees may also be appointed in Chapter 7 liquidations. *See* 11 U.S.C. § 705(a) (2000) (providing that unsecured creditors of a debtor in Chapter 7 may elect a creditors' committee).

[62] A few narrow classes of unsecured claims enjoy priority over other unsecured creditors. *See* 11 U.S.C. § 507(a) (establishing a hierarchy of claims).

[63] *Id.* §§ 363-364 (2000).

[64] *See, e.g.*, *id.* § 1129(b)(1) (providing that a plan of reorganization should be confirmed "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan"); *see also id.* § 1123(a)(4) (requiring a plan of reorganization to "provide the same treatment for each claim or interest of a particular class").

[65] Pro rata distribution means that all creditors in a given class get the same proportion of the face value of their claims. To illustrate, if one member of a class receives sixty cents for each dollar of debt, then all other members of the class should be reimbursed at the same ratio.

[66] *See* 11 U.S.C. § 1129(b)(2)(B) (requiring that a plan of reorganization—"[w]ith respect to a class of unsecured claims—(i) . . . provides that each [member of a class] receive or retain on account of such claim property of a value . . . equal to the allowed amount of such claim; or (ii) [claimants] junior to the claims of such class will not receive or retain under the plan . . . any property").

[67] *See id.* §1102(a) (providing for the creation of a committee of creditors or equity security holders after a Chapter 11 order).

[68] *See id.* § 1102(b)(1) ("A committee of creditors . . . shall ordinarily consist of the persons . . . that hold the seven largest claims against the debtor . . . .").

claims to be represented."[69] In practice, the committee is often chosen to be representative of the interests of a diverse group of creditors. Unless the court finds that other committees are necessary because of conflicts of interests between unsecured creditors,[70] the committee is well placed to represent the interests of unsecured creditors in a coherent fashion and to mediate conflicts between unsecured creditors.

B. *Debt Compensation for Managers*

Part II detailed the difficulty of "incentivizing" managers in bankruptcy. 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.[71] This right to grant debt compensation can be created in one of two manners: either by statute or through a compensation contract drafted by the debtor's board of directors. In either case, the compensation would be subject to the committee's approval.[72] As the bankrupt corporation's board of di-

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[69] *Id.*

[70] *See* BAIRD, *supra* note 1, at 18. In large bankruptcies, several committees may be formed to represent the interests of unsecured creditors with different contractual rights to the assets of the bankrupt company. *See* 11 U.S.C. § 1102(a)(2) ("On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee."). Although a variety of factors are pertinent to this two-step evaluation, courts tend to focus on (1) the presence of conflicted interests between the moving parties and the existing committee, (2) the costs associated with appointment, and (3) the stage of the case. *See In re* Hills Stores Co., 137 B.R. 4, 6 (Bankr. S.D.N.Y. 1992) (evaluating the adequacy of a committee by examining conflicting interests and the potential cost of creating additional committees, and listing "the nature of the case" as a factor to be evaluated); *In re* McLean Indus., Inc., 70 B.R. 852, 860-61 (Bankr. S.D.N.Y. 1987) (acknowledging that while the test for determining the adequacy of a committee's representation is "necessarily vague," two benchmarks include the presence of a potential conflict and cost).

[71] If there are multiple classes of secured creditors, then a compensation right can be granted to the junior secured creditors. Although this Article focuses on Chapter 11 bankruptcies, if a committee exists in a Chapter 7 bankruptcy, *see* 11 U.S.C. § 705(a) (providing for creditors' committees for Chapter 7 bankruptcies), then this committee should have the same powers as the unsecured creditors' committee of a Chapter 11 debtor.

[72] Because creditors are the typical residual claimants in bankruptcy, any compensation contract chosen by the board of directors effectively spends the creditors' money. As a result, allowing the corporation's board of directors to grant debt (a cost imposed on the creditors) is not as radical a departure as it may seem since the compensation granted to the manager comes from the creditors in either case. As shown below, debt compensation provides many advantages to the creditors that are unob-

rectors may not zealously pursue the creditors' best interests (despite the board's fiduciary duties), the statutory route is preferable because it enables the committee to implement debt compensation without interference from the board.

Under either mechanism, if the majority of the members of the committee approves a given percentage of debt compensation and the percentage meets a number of guidelines detailed later in this Article,[73] then the manager should receive the given percentage of all the noncontingent unsecured claims on the company.[74] 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.[75] Every unsecured creditor would be bound by this decision of the committee. To balance the committee's right, equity claimants should also be allowed to grant the manager a percentage of their claims, but the percentage must be the same as that granted by the general unsecured creditors. The committee's right to grant debt compensation should not be absolute. Indeed, the court should have the right to veto the proposal if it feels that the proposal unduly jeopardizes the interests of other interested parties. The risks of debt compensation and the appropriate responses to these risks will be covered in Part IV.

Our example helps illustrate how the proposal would operate. Assume for simplicity that the value of Firm is realized in cash upon liquidation or reorganization at the moment Firm successfully concludes bankruptcy.[76] Now suppose that Firm's committee chooses (by majority vote) to adopt the debt compensation scheme and award Manager

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tainable with ordinary compensation contracts. Unsecured creditors may therefore prefer debt compensation to other forms of managerial compensation.

[73] *See infra* Part IV (discussing the potential responses to problems with a debt compensation plan).

[74] If a contingent claim subsequently becomes noncontingent (e.g., through a judgment in a lawsuit), then the manager should be awarded the agreed-upon percentage whenever the claim is no longer contingent.

[75] *See infra* Part IV.D (examining the consequences of allowing managers to hold debt claims in the reorganized company).

[76] In reality, Manager would receive the same securities that the original creditor received in exchange for its unsecured debt. *See infra* Part IV.D (discussing this complication in further detail).

3% of the unsecured debt of Firm. Following this vote, every unsecured creditor must relinquish 3% of the face value of her debt to Manager. If Creditor *A* owns debt with a face value of $1 million, then Manager would receive debt with a face value of $30,000 (3% of Creditor *A*'s $1 million). Creditor *A* would then be left with unsecured debt with a face value of $970,000. In total, Manager will get unsecured debt in Firm with a face value of $1.5 million (3% of Firm's $50 million), where $50 million is the total face value of Firm's unsecured debt (Assumption 1).

Now suppose that the value of Firm in reorganization is $15 million and that Manager receives no salary other than the percentage of the unsecured debt. Efficiency dictates that Firm should be liquidated, because its liquidation value of $20 million (Assumption 2) is greater than the reorganization value of $15 million. In ordinary circumstances, however, Manager might be reluctant to liquidate rather than reorganize because, among other things, liquidation means Manager is out of a job. For this example, assume that Manager values a future job with Firm at $100,000.

Now compare Manager's salary under the debt compensation scheme if Manager chooses to liquidate versus reorganize. If Manager liquidates, Firm would realize $20 million. The absolute priority rule provides that secured creditors, whose claims total $10 million, would be paid in full. This means that $10 million would remain for unsecured creditors (equity would get nothing), who have claims with a face value of $50 million. The "fair and equitable" principle provides that the unsecured creditors must share these proceeds pro rata.[77] Thus, each creditor would receive twenty cents for each dollar of face value (.20 = $10 million ÷ $50 million). Manager's portion of the debt would be valued at $1.5 million; thus, she would receive $300,000 in compensation ($300,000 = .20 × $1.5 million).

On the other hand, if Manager chooses to reorganize, then Firm would realize only $15 million in value. After paying the secured creditors, Firm would be left with $5 million for the unsecured claimants, thus leaving each unsecured creditor with only ten cents on the dollar (.10 = $5 million ÷ $50 million). Manager would receive $150,000 ($150,000 = .10 × $1.5 million).[78]

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[77] *See supra* notes 64-65 and accompanying text (noting that the Bankruptcy Code requires a reorganization plan to be fair and equitable in order to be confirmed, which mandates pro rata distribution).

[78] Recall that Manager was granted debt with a face value of $1.5 million.

Thus, Manager's compensation under reorganization is $150,000 less than her return under liquidation. Recall that Manager valued the prospect of a future job with Firm if Firm reorganized at $100,000. Accordingly, the self-interested Manager will make the efficient choice (liquidation) because, from her view, liquidation yields greater overall benefits than reorganization. Without the debt compensation scheme, however, Manager would have made the inefficient choice (reorganization) because reorganization ensured Manager a job. For example, if Manager received the same salary under liquidation or reorganization, then Manager would choose reorganization, because it gives her a future job with a value of $100,000.

By ensuring that Manager would choose the efficient option, the debt compensation scheme created value for unsecured creditors. For example, although Creditor *A* gave up 3% of her debt to Manager, she benefited because she realized a greater return on the face value of her debt. With liquidation, Creditor *A*'s debt would be worth $194,000 (.20 × $970,000 = $194,000). Without debt compensation, by contrast, Manager would choose reorganization, leaving Creditor *A* with only $100,000 ($100,000 = .10 × $1 million).[79] Thus, an unsecured creditor might have good (and efficient) reasons to relinquish some debt in order to improve Manager's incentives.

C. *Why Debt Compensation Is an Improvement upon Existing Means of Managerial Compensation in Bankruptcy*

In the preceding example, it was no coincidence that debt compensation facilitated the efficient result. Debt compensation aligns the incentives of managers with the incentives of the typical residual claimants in bankruptcy—the unsecured creditors. As a result, debt compensation encourages a manager to pursue actions that are in her self-interest, while also improving the return of the unsecured creditors. Just as grants of stock options and restricted stock are believed to foster good behavior in managers of solvent firms, so too does unsecured debt compensation promote value-maximizing behavior in managers of bankrupt firms. This alignment of a manager's incentives with those of bankruptcy's typical residual claimants makes debt compensation an improvement upon other pay-for-performance plans and proposals.

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[79] Note that this example understates the benefit of debt compensation versus salary for Manager because it assumes that, if debt compensation is not adopted, Manager's salary is zero—an obviously unrealistic assumption.

1. Improvement over Pay-To-Stay Bonuses

Just like pay-to-stay bonuses, debt compensation provides an incentive for managers to remain with an insolvent firm. A manager who might receive a percentage of the unsecured debt in the firm enjoys the prospect of a large payment upon the completion of bankruptcy. As a result, debt compensation should accomplish the goal of pay-to-stay bonuses—decreasing the incentive of managers to leave the "sinking ship."[80] Unlike pay-to-stay bonuses, debt compensation accomplishes additional goals as well. By aligning incentives and encouraging the manager to stay with the firm, debt compensation offers better performance per dollar of compensation value, making debt compensation clearly superior to simple pay-to-stay bonuses.

2. Improvement over Rapid-Reorganization Bonuses

As discussed earlier, reorganization speed is only loosely correlated with efficiency.[81] As a result, rapid-reorganization bonuses may engender value-destroying incentives for managers. Debt compensation, by contrast, correlates managerial compensation much more closely with value maximization. Consequently, debt compensation better improves managerial performance.

Recall our example in Part II.B.2, wherein Manager faced a decision to hire consultants to accelerate the reorganization process. Suppose that if Manager does not hire the consultants, Firm will be worth \$30 million in reorganization. If Manager hires the consultants, then Firm will be worth \$35 million in reorganization (because of a faster reorganization), but Firm will incur \$10 million in costs, for a net value of \$25 million. The unsecured creditors would prefer that Manager not hire the consultants because they cost more than they are worth. If Manager is to receive a rapid-reorganization bonus, however, Manager will have an incentive to hire the consultants regardless of the effect on the unsecured creditors.

Now assume that Manager receives debt compensation of 3% of the face value of the unsecured debt. If Manager hires the consultants, then (after paying the secured claimants in full) \$15 million re-

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[80] *See supra* Part III.B (calculating the greater financial incentive a debt compensation plan gives Manager).

[81] *See supra* Part II.B.2 (evaluating a compensation plan that is tied to the speed of reorganization).

mains for unsecured creditors.[82] Unsecured creditors then would receive thirty cents on the dollar (.30 = $15 million ÷ $50 million). Therefore, Manager's $1.5 million in debt would be worth $450,000 ($450,000 = .30 × $1.5 million). If, however, Manager chooses not to hire the consultants, then $20 million would remain for unsecured creditors in reorganization,[83] meaning that they would receive forty cents on the dollar (.40 = $20 million ÷ $50 million). Manager's compensation would then be worth $600,000 ($600,000 = .40 × $1.5 million). Given these incentives, Manager would make the efficient choice and not hire the consultants. Thus, this example demonstrates how debt compensation improves upon rapid-reorganization bonuses by providing a closer alignment between managerial performance and managerial compensation.

Note that debt compensation dictates the efficient outcome in the opposite case as well—if the consultants add value, then Manager would hire them. Suppose that the consultants add $15 million in value to Firm for the cost of $10 million. In this case, $25 million remains for unsecured creditors after secured creditors are satisfied, giving each unsecured creditor fifty cents on the dollar (.50 = $25 million ÷ $50 million). Manager's debt then would be worth $750,000 ($750,000 = .50 × $1.5 million). Because $750,000 is greater than the $600,000 that Manager would receive if the consultants were not hired, Manager would hire the consultants, as efficiency dictates. Debt compensation thereby ensures that consultants are hired when they add value and are not hired when they do not. Rapid-reorganization bonuses, however, bias Manager in favor of hiring consultants even when the consultants do not add value.

3. Improvement over Percentage-of-Assets Plans

Percentage-of-assets plans help ensure that managers maximize value if liquidation is the clear choice.[84] These plans, however, suffer from two flaws. First, if liquidation is not the clear choice, then percentage-of-assets plans may skew incentives toward inefficient liquida-

[82] Hiring the consultants makes the net value of Firm $25 million. Secured creditors are owed $10 million, leaving a residual value of $15 million for unsecured creditors.

[83] Not hiring the consultants makes the value of Firm $30 million. After paying the secured creditors in full, this leaves $20 million for unsecured creditors.

[84] *See supra* Part II.B.3 (discussing the benefits and limitations of percentage-of-assets plans).

tion. Second, these plans may be overly expensive. Debt compensation, by contrast, provides incentives for managers to make the efficient choice between liquidation and reorganization in all contexts. Debt compensation also provides higher-powered incentives than percentage-of-assets plans, making it the less expensive of the two options.[85]

Recall the example presented in Part II.B.3.a. Firm is worth $15 million in reorganization and $10 million in liquidation. If Manager gets 3% of assets in liquidation and an $80,000 salary upon reorganization, then Manager will choose liquidation, in spite of the fact that reorganization is the efficient choice. Consider the same scenario when Manager receives 3% of unsecured debt. If Manager chooses liquidation, all of Firm's $10 million of value goes to pay secured creditors, leaving unsecured creditors with nothing. Manager, whose debt is unsecured, would receive nothing. If Manager chooses reorganization, however, then $5 million would be left over after the secured creditors are compensated. Manager's $1.5 million of debt compensation is therefore worth $150,000 ($150,000 = $1.5 million × ($5 million ÷ $50 million)). Thus, Manager is encouraged to choose reorganization—the efficient choice, because her incentives are closely aligned with the interests of the residual claimants.

Debt compensation may also provide higher-powered and less expensive incentives than percentage-of-assets plans. Returning to the example in Part II.B.3.b, suppose that liquidation is the best option for Firm. With good managerial performance, the liquidation value of Firm would be $12 million; with bad performance, the liquidation value would be $10 million. Now suppose Manager is awarded 3% of assets. If Manager performs well, she would receive $360,000 (.03 × $12 million = $360,000), but if Manager performs poorly, she would receive only $300,000 (.03 × $10 million = $300,000). Under these assumptions, the percentage-of-assets plan provides Manager with appropriate incentives. Because Manager shares the increase in value with creditors, Manager will self-interestedly attempt to garner the higher liquidation value for Firm.

This same incentive is also assured by the percentage-of-assets plan, but to a lesser degree. The difference in compensation between the good and the bad performance states ($60,000) is a small per-

[85] Although debt compensation plans are less expensive than percentage-of-assets plans, cost remains an important obstacle to the use of debt compensation. *See infra* Part IV.A.

centage of the total guaranteed compensation of $300,000. The percentage-of-assets plan may therefore be called "low powered" in the sense that it requires a considerable total expenditure of money to create sufficient incentives for the appropriate managerial behavior;[86] over $300,000 must be spent to generate $60,000 in incentives.

Contrast this with the outcome using debt compensation. Suppose that the unsecured creditors grant Manager 3% of unsecured debt. If Manager performs poorly, then Firm would be worth $10 million. This amount only suffices to compensate the secured creditors; the unsecured creditors would receive nothing. As a result, Manager's 3% stake in unsecured debt has no value. If Manager performs well, by contrast, then Firm would be worth $12 million. After paying the secured creditors, unsecured creditors are left with $2 million, meaning they would get four cents per dollar of debt (.04 = $2 million ÷ $50 million). Manager's $1.5 million in face value is therefore worth $60,000 ($60,000 = .04 × $1.5 million).

Debt compensation gives Manager the same incentive to attain the good result (an additional $60,000) as the percentage-of-assets plan, but at a much cheaper cost. Whereas the percentage-of-assets plan would grant Manager at least $300,000 in any scenario, debt compensation only rewards good performance. Debt compensation therefore offers higher-powered incentives than percentage-of-assets plans.[87]

This more preferable incentive structure is achieved by not offering Manager a percentage of the secured debt. This makes good sense; secured creditors should not compensate Manager, because they do not depend on her performance in order to receive payment. As a result, granting Manager a percentage of Firm that is reserved for secured creditors is wasteful.[88] The debt compensation approach avoids this problem by granting Manager a percentage of unsecured debt exclusively.

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[86] See *supra* note 45 for a definition of low-powered incentives.

[87] In reality, of course, Manager will always receive some compensation. The purpose of the example is to show that debt compensation creates tailored incentives that are superior to the blunt approach of the percentage-of-assets scheme.

[88] In the typical bankruptcy, secured creditors get paid in full. *See* Bris et al., *supra* note 18, at tbl.8 (indicating that the average secured creditor is paid in full). Thus, the example is realistic in suggesting that secured creditors get paid in full in every eventuality. When secured creditors will not be paid in full (for example, if there are junior secured creditors), the junior secured creditors should participate in the debt compensation plan.

Debt compensation therefore ameliorates two of the primary flaws of the percentage-of-assets plan: it does not skew incentives to liquidate, nor does it cost as much.

4. Improvement over Equity Compensation Plans

As explained in Part II.B.4, equity compensation plans suffer from a number of defects. Two prominent defects are skewed incentives to create an efficient capital structure and skewed incentives to provide accurate valuations of debt as opposed to equity. Debt compensation mitigates or eliminates both of these defects.

Debt compensation gives managers incentives to shape an efficient capital structure for reorganized firms. To illustrate, return to the example presented in Part II.B.4.a. In this version of the example, a debt-equity ratio of 1 to 1 adds value to the reorganized Firm by mitigating agency problems.[89] Firm is worth \$40 million with this debt-equity ratio, but only \$30 million when the Firm has an all-equity structure. If Manager receives equity compensation, she has incentives to fashion a less efficient all-equity capital structure because the greater the value of equity, the greater Manager's return.

With debt compensation, by contrast, Manager would choose the appropriate capital structure. Assume that Manager receives 3% of unsecured debt. If Manager chooses the all-equity capital structure, then \$20 million would remain for unsecured creditors after secured creditors are satisfied. Manager's \$1.5 million face-value debt would therefore be worth \$600,000 (\$600,000 = \$1.5 million × (\$20 million ÷ \$50 million)). If Manager chooses the more balanced capital structure, by contrast, then \$30 million would remain for unsecured creditors, meaning that Manager would receive \$900,000 (\$900,000 = \$1.5 million × (\$30 million ÷ \$50 million)). Thus, Manager will choose the efficient capital structure when receiving debt compensation. Because reorganization of the capital structure is one of Manager's essential roles in bankruptcy, this feature of debt compensation constitutes a significant advantage over equity compensation plans.

With debt compensation, Manager also will have no incentive to overvalue debt with respect to equity. If Manager produced an overestimate of the value of debt in the reorganized Firm relative to equity, then Manager's equity compensation would be underestimated.

[89] For an explanation of how debt's presence in capital structure can add value, see *supra* note 48.

While Manager may prefer this combination when receiving equity compensation because it understates the value of her compensation, she has no such incentive with debt compensation. So long as Manager provides a reasonably accurate description of the total value of the company, her total compensation will appear the same regardless of whether she exaggerates the value of one class of securities with respect to another. As a result, Manager has no incentive to misestimate the values of different securities. With greater confidence in Manager's valuations, creditors can place more reliance on these estimates when choosing whether to vote for a plan of reorganization. Courts will also benefit from greater confidence in Manager's estimations when deciding whether to confirm or to reject a plan of reorganization.[90]

This Section has examined the superiority of debt compensation with respect to many alternative forms of managerial compensation in bankruptcy. Unlike these other compensation structures, debt compensation provides incentives for efficient managerial actions without creating incentives to distort the process of reorganization. As such, debt compensation presents an important new tool for improving managerial performance in bankruptcy.

5. Improvement of the Functioning of the Creditors' Committee

At present, creditor participation on the creditors' committee suffers from free-rider problems.[91] All of the creditors share the benefits of the increase in value created by the committee's monitoring of the debtor. Only the creditors on the committee bear the costs of monitoring, however. The other creditors free ride on the committee's efforts.[92] As a result, creditors are reluctant to join the creditors' com-

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[90] A plan of reorganization must meet several criteria in order to receive court approval. Whether or not a plan meets the criteria will depend critically on valuations of different securities. For example, it is impossible to know if a plan meets the "best interests of the creditors" test without evaluating the disbursements to claimants. *See* 11 U.S.C. § 1129(a)(7) (2000) (describing what is commonly called the "best interests of the creditors" test and requiring that a reorganization plan provide creditors with no less than they would have received in liquidation).

[91] J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 271 (1991) ("It is not surprising . . . why unsecured creditors are hesitant to become members of a creditors' committee. It is clearly to the advantage of an unsecured creditor to adopt a 'free-rider' strategy . . . and hope that some other unsecured creditor will . . . bear the cost of serving on the committee.").

[92] *See* BAIRD, *supra* note 1, at 18 (noting that the committee is "not compensated for [its] efforts" and "[m]oreover, as a member of the committee, a creditor is charged

mittee or, if they do join, to monitor the debtor efficiently. The free-rider problem therefore undermines the effectiveness of the creditors' committee in protecting the creditors' interests.

Debt compensation mitigates this problem in a number of ways. By aligning the incentives of managers with those of creditors, debt compensation reduces the need for monitoring. With debt compensation, managers self-interestedly pursue actions that benefit the creditors, decreasing the importance of effective creditor monitoring. The salience of the free-rider problem is thereby reduced.

Debt compensation also raises the incentive for creditors to join the creditors' committee. Debt compensation confers an important new power on the members of the committee—the ability to influence the use or non-use of debt compensation. This power would be particularly important to the largest creditors, who have the most to gain or lose through debt compensation. Consequently, debt compensation raises the incentive for these creditors to join the committee by adding to the advantages of committee service.

By encouraging large creditors to join the creditors' committee, debt compensation enhances the ability of that committee to oversee the manager. Large creditors are often the most sophisticated parties with the best ability to monitor. In addition, large creditors are less likely to free ride. If one creditor holds half the debt of a bankrupt company, then that creditor enjoys half the gains of its monitoring efforts while bearing all the costs of these efforts. While even this creditor will monitor less than optimally because of mismatched incentives, the large creditor's monitoring efforts should be greater than those of a small creditor. A small creditor garners a much smaller proportion of the gains of monitoring than the large creditor, while continuing to bear the full cost of the monitoring efforts. By raising the incentive for creditors with superior monitoring ability to join the creditors' committee, debt compensation improves the ability of the committee to monitor the debtor.

By improving managerial incentives and the functioning of the creditors' committee, debt compensation constitutes an important advance in managerial compensation in bankruptcy. It is not without (surmountable) complications, however, as the next Part demonstrates.

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with looking out not only for its own interests but also for those of the other general creditors").

IV. WEAKNESSES OF DEBT COMPENSATION AND POTENTIAL RESPONSES

Although debt compensation for managers in bankruptcy offers many advantages over other compensation structures, it is no panacea. Several potential flaws and complications may obstruct debt compensation's efficacy. These flaws include debt compensation's expense, the creation of managerial biases in favor of some groups of creditors with respect to others, and the difficulty of unwinding the debt compensation structure once a firm has reorganized. While none of these complications is insoluble, judges and lawmakers must shape the debt compensation approach to ensure that the benefits described above are realized. This Part examines the potential shortcomings of debt compensation and discusses means of mitigating these weaknesses.

A. *Debt Compensation's Expense*

High expense may plague the debt compensation approach. As discussed with respect to the percentage-of-assets plan,[93] percentage compensation provides low-powered incentives—improved performance only raises a manager's pay by a small percentage of the total compensation.[94] Moreover, debt compensation bears some resemblance to stock options and other executive compensation plans that have recently fallen into ill repute for granting managers large windfalls without improving performance.[95] If debt compensation improves performance by a little but costs a lot, then it may not be worth the trouble.

High expense should not obstruct debt compensation for two reasons. First, as noted above, debt compensation does not simply award the manager a percentage of the entire firm. Because secured debt is likely to be repaid in any event, managerial incentives are not improved by awarding the manager a percentage of secured debt. In response, debt compensation excludes secured debt. By focusing the

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[93] *See supra* Part II.B.3.b.

[94] For a discussion of low-powered incentives, see Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138, 140.

[95] For a comprehensive discussion of the failure of pay-for-performance incentives, see BEBCHUK & FRIED, *supra* note 3, at 6-7; Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 261-62 (1990). *But see* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 654-55 (1998) (finding that CEO compensation is strongly related to firm performance and attributing this relationship to stock option grants).

incentive compensation on the typical residual claimant—the unsecured creditor[96]—debt compensation facilitates higher-powered incentive compensation. Second, debt compensation is voluntary; creditors' committees can choose not to employ the plan if it is believed to be too expensive.

1. Opt-out for Senior Unsecured Creditors

Excluding secured creditors from debt compensation improves the "power" of debt compensation and ensures that secured creditors will not be forced to pay for compensation that does not yield them considerable benefits. Debt compensation may still be low powered, however, if secured debt is small relative to unsecured debt. If a bankrupt firm's entire debt load is unsecured, for example, then the secured debt exception does not foster higher-powered incentives. As a result, debt compensation may prove to be low powered and to cost more than it is worth under some circumstances.

Allowing some senior classes of unsecured creditors to opt out of debt compensation would heighten the impact of each debt compensation dollar on managerial performance. As discussed above, all unsecured creditors are not alike. Some debt contracts give some unsecured creditors priority with respect to other unsecured creditors. The Bankruptcy Code recognizes this eventuality by providing for the establishment of additional creditors' committees when "necessary to assure adequate representation of creditors."[97]

Senior unsecured creditors should be allowed to "opt out" (as a group) of the debt compensation package. To illustrate this, modify Assumption 1 of our example from Part I so that there are no secured creditors of Firm. Instead, suppose that senior unsecured creditors hold \$15 million in face value-debt, while general unsecured creditors are owed \$35 million. Assume that a senior unsecured creditors' committee has been appointed to protect the interests of the senior lenders. Suppose also that Firm will be worth \$20 million or \$25 million, depending on Manager's performance. Finally, assume that the unsecured creditors' committee, representing ordinary unsecured creditors, grants 3% of debt to Manager.

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[96] *See* Bris et al., *supra* note 18, at tbl.8 (finding that although debts to secured creditors are typically satisfied, debts to unsecured creditors often are not).

[97] 11 U.S.C. § 1102(a)(2) (2000).

If the unsecured creditors' committee's decision binds all unsecured creditors, then Manager would receive $1.5 million ($1.5 million = .03 × $50 million) of face value of unsecured debt. Senior unsecured debt would make up $450,000 ($450,000 = .03 × $15 million) of this face value, while $1.05 million ($1.05 million = .03 × $35 million) of this debt would be general unsecured debt. If Firm is worth $20 million, then the absolute priority rule provides that the senior unsecured creditors would get paid in full while the general unsecured creditors would receive the $5 million that remains after the senior unsecured creditors are fully compensated. In this case, Manager's senior unsecured debt would be worth $450,000 while her general unsecured debt would be worth $150,000 ($150,000 = $1.05 million × ($5 million ÷ $35 million)), for a total compensation of $600,000. If Firm is worth $25 million, then Manager's senior unsecured claims would be worth $450,000 while her general unsecured debt would be worth $300,000 ($300,000 = $1.05 million × ($10 million ÷ $35 million)), for a total of $750,000. Thus, Manager's salary would increase by 25% (.25 = ($750,000 - $600,000) ÷ $600,000) with good performance.

If senior unsecured creditors are allowed to opt out of debt compensation and form a senior unsecured creditors' committee (a likely outcome when senior unsecured creditors constitute a large group of creditors),[98] then this committee should vote on whether or not to participate in the debt compensation plan by awarding the manager the same percentage of senior debt chosen by the official unsecured creditors' committee. When there is no senior creditors' committee, senior creditors should vote to opt in or opt out of the debt compensation. If a majority (by value)[99] of a given class of senior creditors votes to opt out of debt compensation, then the manager would receive no senior debt. But if a majority votes to opt in, then the man-

[98] Some courts have stated that the "chief concern [in deciding whether or not to appoint an additional committee] . . . is whether it appears that different classes of debt and equity holders may be treated differently under [the] plan and need representation through appointment of additional committees." *In re* Drexel Burnham Lambert Group, Inc., 118 B.R. 209, 212 (Bankr. S.D.N.Y. 1990). Conflicts between senior creditors and other creditors are extremely common when there is a large group of senior unsecured creditors. In these circumstances, it is quite likely that a committee will be appointed to represent senior unsecured creditors.

[99] Alternatively, opting out of a debt compensation plan may require a two-thirds majority by value and a simple majority by number of senior unsecured creditors. This two-thirds in value, one-half in number rule is the standard used for confirmation of a plan of reorganization by an impaired class of creditors.

ager would receive a percentage of all the senior debt (including the debt of those who vote against the proposal).[100]

In our example, senior unsecured creditors would vote to opt out of debt compensation. No matter how Manager performs, Firm would be worth more than $15 million, meaning that the senior creditors would be paid in full under any eventuality. As a result, senior creditors would refuse to relinquish any of their debt as compensation to Manager. The opt-out by senior creditors renders debt compensation a more effective and less expensive means of compensation. When senior creditors opt out, Manager would receive $1.05 million in face value of general unsecured debt, which is 3% of the total general unsecured debt. This means that if Manager performs poorly, she would earn $150,000 ($150,000 = $1.05 million × ($5 million ÷ $35 million)); if she performs well, she would receive $300,000 ($300,000 = $1.05 million × ($10 million ÷ $35 million)).

The absolute size of the incentive for Manager to perform well (an extra $150,000) is thus the same whether or not senior creditors choose to opt out. When senior creditors opt out, however, the total cost of managerial compensation goes down by $450,000 because senior creditors are not forced to turn over debt to Manager. Thus, allowing senior creditors to opt out reduces the potentially high costs of debt compensation while retaining the same positive impact of managerial incentives.

2. Debt Compensation Is a Voluntary Plan

The strongest defense against debt compensation's high expense is that it is voluntary—creditors' committees can choose whether or not to employ the plan. If debt compensation is not worth the expense, the committee is free to reject it. If creditors believe that debt compensation is worth the cost, however, then the law should facilitate its use. Just as shareholders of corporations are free to grant equity to managers to improve managerial compensation, so too should creditors be allowed to arrange similar pay-for-performance plans in bankruptcy.

Many commentators criticize non-bankruptcy pay-for-performance plans for promising more than they deliver. If a manager effectively controls a board, for example, then the manager may be able to gar-

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[100] For a discussion of why a majority vote should be binding on all creditors, see *infra* Part IV.B.1.

ner outsize compensation that is labeled "pay-for-performance," but is actually a large handout that provides few positive incentives to the manager.[101] "Pay-for-performance" underperforms ordinary compensation in these circumstances.

While these flaws caution against slavish reliance on pay-for-performance, they are unlikely to be as salient with regard to debt compensation in bankruptcy. A manager is unlikely to enjoy the same control over a creditors' committee that she sometimes enjoys over a board of directors.[102] As commanded by statute, creditors' committees must be composed of large or representative creditors.[103] A manager cannot nominate candidates, nor does she have a seat on the committee. As a result, a manager cannot dominate a creditors' committee in the same way that she might dominate a board of directors. Debt compensation for managers in bankruptcy is therefore more likely to reflect sound business decision making by the creditors' committee than rent-seeking behavior by the manager.

In spite of debt compensation's voluntariness, courts should remain vigilant for abuses. If a court feels that debt compensation results from managerial domination of the creditors' committee rather than business fundamentals, the court should reject the debt compensation plan.[104] By requiring the approval of a third party to grant debt compensation, the worst managerial compensation abuses should be avoided.

B. *Conflicts Between Creditors Caused by Debt Compensation*

Some creditors may be harmed by debt compensation. If the plan causes managers to favor one group of creditors over another, then its benefits may be outweighed by its costs. While fears of inefficient behavior by debt-compensated managers may be overstated by some

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[101] Scholars have suggested that "pay-for-performance" plans often fail to achieve their purpose. *See supra* note 95 (citing sources debating the effectiveness of pay-for-performance).

[102] For examples of the way managers can sometimes dominate the boards of directors of companies outside of bankruptcy, see Michael J. Wolf, Op-Ed., *Media Mutiny*, WALL ST. J., Dec. 8, 2003, at A14.

[103] 11 U.S.C. § 1102(b)(1) (2000).

[104] Although such determinations are typically difficult for courts to make, the detailed involvement of the court with the affairs of a bankrupt company means that the court will have some basis on which to make the determination. Moreover, the court will have other reasons, described *infra* Part IV.F, to reject debt compensation plans that may result in very large payoffs to managers.

groups of creditors, there will occasionally be some merit to these claims. To prevent debt compensation from causing inefficient managerial behavior, courts should follow some of the guidelines presented here before approving a debt compensation plan.

As a general matter, it should be emphasized that the fact that some groups of creditors are harmed by debt compensation is not reason to doubt its usefulness. Bankruptcy procedures strive to obtain the greatest value from the bankrupt firm, not to satisfy any particular group of creditors.[105] If debt compensation maximizes value, even while harming one group of creditors, then it adds value and should still be encouraged.

1. Conflicts Among General Unsecured Creditors

Although it is unlikely that all general unsecured creditors will be happy with the decision to grant debt compensation, they must all be bound by the decision of the creditors' committee. Binding all creditors prevents free riding by some. If some general unsecured creditors were allowed to opt out of granting debt compensation, they would gain the performance-enhancing benefits of debt compensation without having to pay for them. This potential for free riding may convince many creditors to vote against an efficient debt compensation plan. To prevent this eventuality, a debt compensation award must be binding on all general unsecured creditors.

Making the decision of the creditors' committee binding upon all general unsecured creditors is not a radical idea. Shareholders of a company outside of bankruptcy cannot opt out of stock option plans. Instead, the shareholders are bound by the decision of the board of directors. Similarly, general unsecured creditors should be bound by the decisions of the unsecured creditors' committee.[106]

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[105] *See* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 231-32 (4th ed. 2006) (describing bankruptcy as an attempt to "make the best of a bad situation" and suggesting that the absolute priority rule is not a critical consideration for today's large bankruptcies).

[106] At times, the creditors' committee may also require the debtor to take certain actions. *See, e.g.*, Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel* Cybergenics Corp. v. Chinery, 330 F.3d 548, 580 (3d Cir. 2003) (en banc) (holding that a creditors' committee could sue the company to force it to avoid fraudulent transfers).

2. Conflicts Between Secured Creditors and Unsecured Creditors

Debt compensation runs against the interests of secured creditors. Because a manager's interests are aligned with those of the unsecured creditors, the manager may favor unsecured creditors over secured creditors.

In some circumstances, a manager's tendency to favor unsecured creditors may lead to inefficient outcomes. Returning to the example from Part I, modify Assumption 3 to make reorganization a riskier process. If Firm pursues a reorganization, there is a 60% chance that Firm will be worth $30 million and a 40% chance that Firm will be worthless ($0). Under this assumption, efficiency dictates that Firm should liquidate because its liquidation value of $20 million (Assumption 2) is greater than its expected reorganization value of $18 million ($18 million = (.60 × $30 million) + (.40 × $0)).

Debt compensation will not lead to the efficient outcome under these conditions. Under liquidation, $10 million remains for unsecured creditors after compensating secured creditors. Under attempted reorganization, by contrast, unsecured creditors get an average receipt of $12 million ($12 million = .60 × ($30 million - $10 million) + (.40 × $0)). When Manager receives debt compensation, her percentage of unsecured debt will be worth more (on average) under reorganization than under liquidation. Thus, Manager will choose reorganization, in spite of the fact that liquidation is the efficient choice.

This flaw in debt compensation is not as problematic as it might seem. First, in many cases, the secured creditors are comfortably over-secured.[107] As a result, this scenario should not occur too frequently. Second, the Bankruptcy Code includes many protections for secured creditors. For example, a debtor may not use an asset that provides security for a creditor without providing that creditor "adequate protection" for that asset.[108] Section 361 of the Bankruptcy Code explains that adequate protection means that the secured creditor should not

[107] An over-secured creditor's security interest is worth more than the underlying loan made by the creditor. In this event, the over-secured creditor's interest in the collateral is limited to the value of the claim. 11 U.S.C.A. § 506(a)(1) (West Supp. 2006).

[108] *See* 11 U.S.C. § 362(d)(1) (2000) (granting a secured creditor relief from the automatic stay if the debtor does not provide adequate protection for the asset). Once a secured creditor is granted relief from the stay, that creditor can prevent the debtor from using the asset that acts as security (e.g., by foreclosing on the asset). *See* BAIRD, *supra* note 1, at 177 (explaining that a secured creditor granted relief from the stay can seize its collateral).

suffer a loss in value because the debtor continued to use the secured asset in bankruptcy.[109] If pursuing a plan of reorganization risks the loss of the secured creditor's security, the secured creditor can therefore request relief from the automatic stay imposed by the Bankruptcy Code. Thus, it is not likely that the bankruptcy court will approve actions, like the one described above, that place the secured creditors of a firm in jeopardy of losing their security. The secured creditor protections offered by the Code thus mitigate the chance that debt compensation will unduly harm secured creditors. As a practical matter, these protections appear to work effectively. Recall that secured creditors are paid at least 95% of each claim in more than three-quarters of all Chapter 11 bankruptcies, suggesting that debt compensation should not unduly harm them.[110]

In addition, most managers will not receive debt compensation exclusively. Instead, they will be compensated by a combination of salary and debt. The salary constitutes a priority administrative expense.[111] If the "adequate protection" offered to secured creditors proves insufficient, then the remaining funds owed to the secured creditors have priority over managers' salaries.[112] As a result, managers will experience some loss of compensation if secured creditors are not compensated in full. This provides added protection for secured creditors. In the example presented above, Manager would not receive any salary if she attempted reorganization and Firm had no value. This would make Manager more reluctant to choose an inefficient reorganization over a more efficient liquidation.

If unsecured creditors feel that they have little to lose (if they are out of the money, for example), then they may be willing to grant the manager a very high percentage debt compensation. A very high percentage might encourage inefficient managerial choices. Returning to our example, modify Assumption 2 to make the value of Firm in liquidation $10.4 million rather than $20 million. In addition, modify Assumption 3 to make the value of Firm if it pursues reorganization $30 million with a 10% probability and $0 with a 90% probability. Assume also that Manager receives $400,000 in salary in addition to any debt compensation. Note that under these circumstances, unsecured

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109 11 U.S.C. § 361 (2000).

110 Bris et al., *supra* note 18, at tbl.8.

111 11 U.S.C.A. § 503(b)(1)(A)(i) (West Supp. 2006).

112 11 U.S.C. § 507(b) (2000).

creditors receive nothing if Firm liquidates—the liquidation value equals the value of secured claims and Manager's salary.[113]

Under these circumstances, liquidation is clearly the efficient outcome.[114] If Manager receives debt compensation of 3%, then she would choose liquidation. Manager's desire to preserve her $400,000 salary exceeds her incentive to maximize the value of unsecured debt. The unsecured creditors (who receive nothing under liquidation), however, have nothing to lose by granting Manager much higher levels of debt compensation to encourage her to attempt an inefficient reorganization. Suppose that the unsecured creditors grant Manager 50% of the face value of unsecured debt. In this case, Manager would choose reorganization because her pecuniary incentive to maximize the value of her debt compensation exceeds her salary.[115] In spite of the high debt compensation award, unsecured creditors would gain as well; by encouraging Manager to choose reorganization, the high debt compensation award opens the possibility that unsecured creditors will receive some compensation. Had unsecured creditors not granted such a high percentage, Manager would have chosen liquidation, and then the unsecured creditors would be left with nothing. Thus, in some scenarios, debt compensation can lead to an inefficient outcome despite the presence of managerial salary.

To protect against this outcome, courts should take a number of precautions. First, they should be especially vigilant in protecting secured creditors' rights when managers receive debt compensation. Second, and more importantly, courts should reject debt compensation plans that award overly high percentages to managers.[116] To determine when a percentage is overly high, courts should compare the

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[113] *See* 11 U.S.C.A. § 503(b) (West Supp. 2006) (providing that administrative expenses such as salaries receive priority over ordinary unsecured claims). Thus, Manager's salary must be paid in full before unsecured claimants receive any compensation.

[114] Liquidation realizes $10.4 million. Reorganization yields an expected value of $3 million ($3 million = (.10 × $30 million) + (.90 × $0)).

[115] If Firm liquidates, Manager receives $400,000. If Firm reorganizes, Manager receives an expected value of approximately $1 million (.10 ($400,000 + .05 ($30 million - $10.4 million)) + (.90 × $0) ≈ $1 million).

[116] To give committees and managers an incentive to choose reasonable percentages, a rule might be adopted that only one debt compensation plan can be put forward to the court. If the court rejects the debt compensation plan, then debt compensation cannot be used with respect to the manager in question. This would prevent the committee from "pushing the envelope" with its debt compensation proposal, secure in the knowledge that if one plan were rejected, the committee could subsequently modify the plan to ensure court acceptance.

percentage of debt received by the debt-compensated manager with the percentage of equity (in the form of stock grants and stock options) granted to managers of similar firms outside of bankruptcy. If the manager's debt compensation percentage is considerably higher than those of her peers outside of bankruptcy, then the court should reject the debt compensation plan because there is a high risk that the plan will create inefficient incentives.

The conflict between secured creditors and unsecured creditors in bankruptcy shares a number of similarities with the conflict between debt claimants and equity claimants in an ordinary company.[117] In these companies, managers are commonly granted stock and stock options, in spite of the fact that such compensation introduces conflicts between creditors' interests and managers' interests. Just as incentive compensation is permitted in these contexts, so too should it be permitted within bankruptcy.[118]

Nevertheless, the threats caused by incentive compensation to the interests of senior creditors are real. Outside of bankruptcy, these creditors receive protections against managerial misbehavior, such as a change in managerial fiduciary duties as companies reach the zone of insolvency.[119] Within bankruptcy, courts should provide the protections described here.

3. Conflicts Between Senior Unsecured Creditors and General Unsecured Creditors

Because senior unsecured creditors may want to provide strong incentives to managers, the availability of debt compensation will often be a positive development for this set of creditors. When senior unsecured creditors do not need to provide such incentives, the opt-out mechanism described in Part IV.A.1 reduces the cost of debt compensation. Even with the opt-out mechanism, however, senior unsecured creditors will occasionally be harmed by debt compensation.

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[117] *See, e.g.*, Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1506 (S.D.N.Y. 1989) (illustrating a situation where bondholders sought relief from an action by shareholders that harmed the value of the bonds).

[118] For an analysis of the "asset substitution" conflict between debt and equity, which is analogous to the conflict described here, see Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 473-75 (1992).

[119] *See supra* note 15 (presenting cases discussing the fiduciary duties to creditors).

The conflicts between senior unsecured creditors and ordinary unsecured creditors parallel those between secured creditors and unsecured creditors. Unsecured creditors who are "out of the money" may grant secured creditors an extremely high percentage of their debt to encourage them to take large risks. If the risks pay off, the unsecured creditors reap much of the benefits. If the risks fail to pay off, however, then the senior unsecured creditors bear much of the cost. As explained above, unsecured creditors may be best off awarding an extremely large percentage in these circumstances. Moreover, senior unsecured creditors do not enjoy some of the protections offered by the Bankruptcy Code to secured creditors.

Because of these concerns, courts should refuse to approve a debt compensation plan that has been rejected by the senior unsecured creditors when (1) there is a large amount of senior unsecured debt relative to total unsecured debt—making it more likely that senior unsecured creditors, and not general unsecured creditors, are the residual claimants of the firm; *and* (2) the debt compensation amounts awarded to managers by the unsecured creditors' committee are excessively large. These conditions indicate a heightened probability that debt compensation is being used to encourage inefficient risk taking rather than value maximization. When these conditions are not present, courts should approve debt compensation plans because they are likely to be efficient.

4. Conflicts Between Equity and Unsecured Creditors

Debt compensation may harm the interests of equity claimants in bankruptcy. Because debt compensation aligns the interests of managers with those of unsecured creditors, managers may favor these creditors' interests over those of equity claimants.[120] If equity holders are the true residual claimants of a firm, then the manager's incentives to improve the value of unsecured debt may be inefficient.

These concerns should not be overstated. First, it is unlikely that equity will be the residual claimant of the firm. When equity is the residual claimant, the firm is solvent. If the firm is solvent, it is unlikely to be in bankruptcy because it should be able to meet its obligations

[120] Because unsecured creditors implement debt compensation by handing a percentage of their claims to the manager, equity claimants do not bear the actual cost of debt compensation.

in full.[121] As a result, debt compensation will only inefficiently skew managerial incentives in the rare case where a solvent firm cannot find financing outside of bankruptcy to resolve a liquidity crunch.

Second, debt compensation functions as a useful corrective against managers' tendency to have "interests closely aligned with the shareholders."[122] Under debtor-in-possession rules, the manager of the bankrupt firm is commonly the pre-bankruptcy manager, who was "only appointed due to equity concerns."[123] In addition, the manager frequently holds stock and stock options in the firm. Given this background, there is a danger that managers will unduly favor the interests of equity. Debt compensation combats this tendency: rather than biasing bankruptcy against equity, debt compensation brings creditors' rights into greater balance with those of equity.

Because of the risk that equity will be harmed by debt compensation, equity holders should be allowed to participate in the compensation plan. To illustrate, suppose that the creditors' committee of Firm grants debt compensation of 3%. If equity has the option of participating, then shareholders will have the right to grant 3% of equity to Manager. This ensures that Manager treats equity's interest just as she treats creditors' interests. With the option to participate in the compensation plan, equity cannot complain that its interests are harmed by debt compensation.

C. *Joint Administration*

Many bankruptcies are jointly administered.[124] When a parent company and its subsidiaries declare bankruptcy at the same time, one bankruptcy court will often "jointly administer" all of the bankruptcy proceedings for this group of companies. Unsecured creditors of the different entities will often have different preferences in these circumstances. For example, a holding company's asset-to-liability ratio may be greater than that of its subsidiaries.[125] In these circumstances, the goals of the holding company's unsecured creditors will diverge from

[121] Indeed, by changing the incentives of managers in bankruptcy, debt compensation serves as a useful check against opportunistic bankruptcies by solvent firms looking to use bankruptcy to alter burdensome contractual or tort obligations.

[122] BAIRD, *supra* note 1, at 182.

[123] *Id.*

[124] *See* FED. R. BANKR. P. 1015(b)(4) (authorizing "joint administration of estates" involving a debtor and an affiliate).

[125] *See, e.g.*, *In re* McLean Indus., 70 B.R. 852, 854 (Bankr. S.D.N.Y. 1987) (describing a solvent parent company and its insolvent subsidiaries).

those of the subsidiary's creditors. Courts have recognized this problem and established a general rule that, "[w]here multiple cases are jointly administered, multiple committees may be more appropriate" to protect the divergent interests of all the creditors.[126]

The potential conflicts among the various groups of unsecured creditors resemble those between senior unsecured creditors and general unsecured creditors discussed earlier.[127] Creditors of an entity with a large number of assets in proportion to debts may prefer not to participate in a potentially expensive debt compensation plan. Creditors of less well-situated entities may see little to lose in granting the manager an outsize percentage. Debt compensation procedures must mediate between these opposing goals.

In jointly administered cases, the committee of unsecured creditors representing the largest group of creditors by value should be entitled to devise a debt compensation plan. Other committees of unsecured creditors should be free to opt out of this plan, just as senior unsecured creditors should be allowed to opt out of debt compensation. If there is only one unsecured creditors' committee,[128] the unsecured creditors of each entity should be allowed to opt out of the debt compensation plan through a vote of all the unsecured creditors.

This procedure allows unsecured creditors with different goals to adopt different solutions. If the largest group of unsecured creditors holds relatively low-value claims, however, then it may attempt to grant the manager a particularly large percentage and force the creditors of the other entities to either opt out or devote an unreasonably large amount to managerial compensation. Such a plan grants the manager inefficient incentives to undertake overly risky projects.[129] To prevent this occurrence, bankruptcy courts should reject plans that grant managers an overly generous percentage. That a percentage is overly high can be determined by comparing the proportion of debt granted to the manager with the proportion of equity granted to managers in comparable firms outside of bankruptcy.

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[126] 7 COLLIER ON BANKRUPTCY § 1102.02[4][a] (Alan N. Resnick et al. eds., 15th ed. rev. 2006).

[127] *Supra* Part IV.B.3.

[128] Even in jointly administered cases, there is no guarantee that multiple committees will be formed. *See, e.g.*, *In re McLean Indus.*, 70 B.R. at 861-62 (describing the factors to consider in determining whether multiple committees are necessary).

[129] For a more detailed discussion of this phenomenon, see *supra* Part IV.B.3.

D. *Manager Has Debt in Reorganized Company*

1. Problems with Debt Holding by Managers

In a reorganization, creditors receive claims against the reorganized company in exchange for their original claims against the firm.[130] The plan of reorganization divides all the creditors into different classes, with all the members of a particular class holding substantially similar claims against the bankrupt firm.[131] Further, the plan determines the structure of the new claims received by each class in exchange for the original claims.[132] The new claims against the firm received by a class might not be the same type of claims as the original claims held by the class.[133] For example, some creditor classes of the original firm might receive cash for their claims.[134] Other classes might receive debt claims in the reorganized company in lieu of their original debt claims.[135] Still others might be required by the plan of reorganization to exchange their debt claims for equity claims in the reorganized entity.[136]

With debt compensation, a manager receives a percentage of the debt of several classes. For example, if senior unsecured creditors choose to remain in the debt compensation plan, they will undoubtedly constitute a different class of creditors than general unsecured creditors. The different classes of creditors may well receive different types of claims in the reorganized firm.

To illustrate, suppose that there are two classes of unsecured creditors of Firm, Class *A* and Class *B*, because Firm has issued two separate series of bonds with different bond indenture contracts but otherwise identical priority levels. Both classes of unsecured creditors join in a debt compensation plan, granting Manager 3% of the face

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[130] *See* BAIRD, *supra* note 1, at 203 ("[F]or the prototypical Chapter 11 case, the old claims against the firm disappear with the discharge and the new obligations of the firm take their place.").

[131] *See* 11 U.S.C. § 1122(a) (2000) (indicating that "substantially similar" claims should be placed in the same class).

[132] *See* BAIRD, *supra* note 1, at 198-222 (describing the formation of a plan of reorganization).

[133] *See, e.g.*, *In re* Johns-Manville Corp., 68 B.R. 618, 621 (Bankr. S.D.N.Y. 1986) (exchanging tort creditors' pre-bankruptcy claims for beneficial interests in a trust consisting of cash and large equity stake in the reorganized firm).

[134] *See, e.g.*, *id.*

[135] *See, e.g.*, *id.* (endowing the trust with the right to receive fixed annual payments for a fixed duration from the reorganized firm).

[136] *See, e.g.*, *id.*

value of debt. Class *A* holds $30 million in face-value debt, while Class *B* holds $20 million. Suppose further that Firm will have an expected value of $35 million after reorganization. Finally, suppose that the plan of reorganization, which was confirmed, calls for Class *A* to receive unsecured debt in the reorganized Firm with a face value of $15 million, while Class *B* receives equity in the reorganized Firm with an expected value of $10 million.

Under these conditions, Manager realizes $450,000 ($450,000 = .03 × $15 million) in debt in the reorganized Firm (from Class *A*) and $300,000 ($300,000 =.03 × $10 million) in equity in the reorganized Firm (from Class *B*) as a result of debt compensation. While this scenario works well in ensuring that Manager designs a value-maximizing and nondiscriminatory plan of reorganization, Manager's post-reorganization incentives are skewed. In the plan of reorganization just described, equity holders are the residual claimants—Firm is solvent after reorganization. Manager's decisions primarily impact the equity holders' return, and not that of the debt holders. Manager's fiduciary duty also lies with the equity holders. In these circumstances, the $450,000 in debt held by Manager as a result of debt compensation constitutes a conflict of interest. Although Manager's fiduciary duty lies with the equity holders, Manager has a pecuniary incentive to maintain the value of debt as well as that of equity. Consequently, Manager may be excessively cautious, choosing to forego profitable but risky investment opportunities because they create a risk that Manager's debt will decline in value. If the debt compensation plan included additional classes of creditors receiving different types of securities, then the conflicts could grow even worse.

2. Responses to These Concerns

As with many of the other critiques described in this Part, this concern should not be overstated. Although managerial incentives are altered when managers hold debt, this problem is not unique to bankruptcy. Almost every manager receives a salary, but, ultimately, salaries in bankruptcy resemble debt.[137] Thus, all managers suffer

[137] Indeed, some aspects of managerial salaries may cause even more managerial risk aversion than will ordinary debt. If the bankrupt company rejects an employment contract with its manager, the manager's damages are capped by the Bankruptcy Code. *See* 11 U.S.C. § 502(b)(7) (2000). To avoid becoming constrained by this provision, managers may make low-risk decisions that minimize the risk of bankruptcy, but do not maximize value.

from split incentives—managers want to increase the value of equity to please their employers and maximize the value of their stock options; managers also strive to protect their salaries by avoiding large (but potentially favorable) risks. Awarding a manager debt in the reorganized firm through debt compensation does not create a new conflict of interest. At worst, it merely contributes to a problem that already exists.

In addition, managerial debt holding creates some positive incentives. When a manager holds debt, she is less likely to engage in inefficiently risky behavior, secure in the knowledge that the downside risks are borne not by equity holders but rather by debt holders.[138] This concern looms large in reorganized companies. Although plans of reorganization must convince the court that the firm will not be forced back into bankruptcy,[139] many once-bankrupt firms wind up in Chapter 11 a second time.[140] Granting a manager some debt reduces the likelihood of this occurrence—the manager has a selfish interest in avoiding a second bankruptcy, which would reduce the value of her debt holdings.

When a manager receives both debt and equity, she has less incentive to exaggerate the value of one security with respect to another in lobbying for the confirmation of a plan of reorganization. If creditors have greater trust in the manager, reorganization will occur more rapidly and efficiently.

3. Possible Modifications to Debt Compensation

In spite of all these positive incentives, post-reorganization debt holding by a manager as a result of debt compensation should be limited for the reasons discussed above. Courts should require managers to sell their debt claims as soon as possible. The larger and more liquid the market for a reorganized company's debt, the greater the speed with which managers should be obligated to sell their debt.[141]

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[138] *Cf.* GRINBLATT & TITMAN, *supra* note 11, at 569, 587 (discussing the asset substitution problem and the ability of management compensation contracts to mitigate this problem).

[139] This "feasibility test" is established by 11 U.S.C. § 1129(a)(11).

[140] Firms that return to bankruptcy a second time are called "Chapter 22s." For a study of Chapter 22s, see generally Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom"*, 54 VAND. L. REV. 231 (2001).

[141] When markets are illiquid, there is a heightened risk that a large sale by a manager would not yield the true value of the debt.

This plan avoids forcing managers to dump all of the debt immediately in a fire-sale fashion and also allows managers to search for a good price. Moreover, the price a manager receives for the debt will be a reflection of the market's (typically accurate) perception of that manager's performance during reorganization.[142] If the market thinks the reorganized company is in dire straits, then that manager will receive little for the debt.

This suggestion ameliorates the incentive-damaging effects of managerial debt holding after reorganization, while retaining the benefits of debt compensation. Because a manager must sell her debt to the highest bidder in a market, she is less likely to push for a shaky plan of reorganization that leaves a high probability of a return to bankruptcy.[143] In addition, there is a reduced chance that debt holding will permanently dissuade the manager from necessary risk taking because the manager must sell her debt as soon as possible. While no plan is perfect, the requirement that a manager sell her debt as soon as possible after reorganization enables debt compensation to proceed without overly jeopardizing the operations of the reorganized company.

E. *Change in Pre-bankruptcy Incentives*

Debt compensation also impacts pre-bankruptcy managerial incentives.[144] When a manager knows that she is likely to receive a portion of the firm's debt should the firm enter bankruptcy, her propensity to file may increase. In addition, the manager may take a different view toward debt in the pre-bankruptcy period. Although

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[142] *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 551-52 (1984) (discussing the relationship between information availability and market efficiency).

[143] The US Airways bankruptcy is one such case. US Airways emerged from bankruptcy in March 2003. Just a few months later, the airline had returned to its shaky financial position and filed for bankruptcy a second time on September 12, 2004. *See Key Dates in US Airways Latest Ch. 11 Filing*, WASHINGTONPOST.COM, http://www.washingtonpost.com/wp-dyn/articles/A16518-2004Sep12.html (last visited Feb. 17, 2007) (listing important developments since US Airways' March 2003 bankruptcy).

[144] *See* Paul Povel, *Optimal "Soft" or "Tough" Bankruptcy Procedures*, 15 J.L. ECON. & ORG. 659, 660 (1999) (discussing the perceived advantages for managers of delaying formal bankruptcy). Plans that would ordinarily encourage prompt bankruptcy filings can lead to counterintuitive results under certain circumstances. *See, e.g.*, Kenneth Ayotte & Yair Listokin, *Optimal Trust Design in Mass Tort Bankruptcy*, 7 AM. L. & ECON. REV. 403, 431-32 (2005) (finding that tort creditor priority in bankruptcy may have the perverse effect of harming rather than helping tort claimants in bankruptcy because tort-creditor priority encourages managers to inefficiently delay a bankruptcy declaration).

both these developments are a change from the status quo, they are not necessarily negative. Indeed, they may bring some welcome changes in managers' pre-bankruptcy behavior.

1. Debt Compensation's Impact on the Propensity To File

Debt compensation potentially raises a manager's total compensation during bankruptcy.[145] Knowing this, a manager of a firm near bankruptcy self-interestedly prefers to file with debt compensation because of the prospect of a higher salary. This tendency may be costly. The legal and administrative costs of bankruptcy are expensive. In addition, bankruptcy sends a frightening signal to employees and other parties engaged with the firm. These parties may curtail or end their relationship with the firm as a result of bankruptcy.[146] Employees with other employment options, for example, will prefer to explore those options rather than face an uncertain future with a shaky organization. By encouraging bankruptcy, debt compensation increases the frequency with which these costs will be borne by the firm—an undesirable development.

Avoiding bankruptcy also has some negative effects. Firms in financial straits suffer from uncertainty. A supplier of a firm with dwindling cash reserves may be reluctant to extend credit whether or not the firm has declared bankruptcy. Furthermore, a near-bankrupt firm enjoys none of the protections conferred by bankruptcy. The firm cannot obtain a stay against any creditor judgments, nor can it bring all of its claims into one forum for a rational reordering. In addition, the firm cannot take advantage of DIP financing that helps reduce uncertainty for many suppliers and other parties contracting with the firm.[147] By encouraging bankruptcy, debt compensation reduces many of these costs.

In addition, it is not clear that debt compensation will increase the prevalence of bankruptcy to an undue degree. Debt compensation accrues only to the manager of the bankrupt firm. In many bank-

[145] This need not be the case. For example, the manager's salary can be reduced to reflect the expected increase in compensation from a debt compensation award.

[146] The availability of DIP financing reduces these trends by ensuring that the debtor has enough cash to maintain everyday operations. DIP financing cannot eliminate the uncertainty associated with bankruptcy, however.

[147] For a discussion of bankruptcy's many benefits, see BAIRD, *supra* note 1, at 15-20.

ruptcies, the manager is fired soon after the bankruptcy declaration.[148] Even if the manager is not fired, the manager does not necessarily receive debt compensation. Instead, the creditors' committee makes this decision. If the creditors' committee feels that the bankruptcy was unwarranted, it is are unlikely to grant debt compensation to the manager. Because of these considerations, the pro-bankruptcy effects of debt compensation should not be overstated.

In many ways, debt compensation's pro-bankruptcy effects are beneficial. The appeal of debt compensation in bankruptcy counterbalances the manager's fear of dismissal as a result of bankruptcy. With the prospect of debt compensation, the manager will be less likely to resist an otherwise efficient bankruptcy to protect her position.

2. Debt Compensation's Impact on Managers' Treatment of Creditors Before Bankruptcy

Debt compensation also changes the way managers will perceive debt as a firm approaches bankruptcy. At present, many factors align the interests of managers with those of equity.[149] As the firm enters the zone of insolvency, this tendency becomes inefficient. Managers make decisions to improve the interests of equity, but their decisions potentially affect creditors' interests a great deal. In particular, managers have an incentive to take on risky projects. If the projects succeed, then bankruptcy is avoided and equity benefits. If the projects fail, then creditors' claims decline in value while equity loses little.[150] For example, suppose that Firm has $60 million in debt outstanding and is worth $55 million if it continues on its present course. Manager can invest in a risky project that will either make the value of the firm $80 million or $20 million, each with 50% probability. The expected value of the Firm with the risky project is $50 million. Thus,

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[148] In both the Enron and WorldCom bankruptcies, for example, the managers brought in after fraud was discovered were fired early in the bankruptcy proceedings, even though they were unconnected to the fraud. *See* Jeffrey Sonnenfeld, *Chief Exec's Selection: A Mystery to Many*, CAREERJOURNAL.COM, Aug. 26, 2003, http://www.careerjournal.com/columnists/managersjournal/20030826-managersjournal.html (discussing the firing of several managers in firms going bankrupt).

[149] *See* Hall & Liebman, *supra* note 95, at 654-55 (noting the linkages between managerial compensation and a firm's equity interests).

[150] For examples of this pattern, see the cases cited *supra* note 15. Firms in the zone of insolvency, by definition, have equity that is of little value. If equity had considerable value, then the firm would not be insolvent.

efficiency dictates that Manager should reject the risky project. From equity's perspective, however, the risky project is best. Equity holders receive nothing if Firm continues on its present course, because Firm's debt obligations exceed its value. By pursuing the risky project, equity's expected payoff becomes $20 million if the project succeeds ($20 million = $80 million - $60 million) and $0 if the project fails. If Manager follows equity's interests, then Manager makes an inefficient decision.

The law recognizes this danger and imposes a unique form of fiduciary duty upon officers of a firm in the zone of insolvency.[151] Here, officers have a fiduciary duty to maximize value rather than to maximize the value of equity. This helps prevent managers from making inefficient decisions that benefit equity but cause a greater detriment to creditors.

While the change in fiduciary duty mitigates the tendency of managers to take inefficient actions as a firm becomes insolvent, it cannot eliminate the problem. As a general matter, breach of fiduciary duty is exceedingly difficult to prove. Unless a manager has taken truly outlandish risks, she will have little trouble arguing that her decisions were motivated by a desire to maximize value.

Debt compensation in bankruptcy improves the incentives of managers to make efficient decisions before bankruptcy. The plan accomplishes this goal by effectively granting the creditors some oversight of the manager. With debt compensation, decisions that hurt the value of debt potentially hurt the manager. Any given percentage of debt will be worth less if the manager makes inefficient decisions before bankruptcy. In addition, the manager knows that the creditors will decide whether or not to adopt debt compensation, as well as the appropriate percentage award. Creditors are unlikely to award debt compensation if they feel that the manager has made inefficient decisions in the pre-bankruptcy period. Anticipating these effects, the manager has less of an interest in engaging in the overly risky behavior that commonly characterizes the pre-bankruptcy period. Thus, debt compensation aligns the pecuniary interests of the manager with her fiduciary duties before bankruptcy as well as within it. For this reason, debt compensation's benefits extend well beyond bankruptcy.

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[151] *See* Pereira v. Cogan, 294 B.R. 449, 519 (S.D.N.Y. 2003) (holding that, under Delaware law, officers and directors of an insolvent firm owe a fiduciary duty to their corporation's creditors); *see also* cases cited *supra* note 15 (exemplifying courts' recognition that creditors are common residual claimants, and are owed fiduciary duties as a result).

F. *Cautious Implementation Should Prevent the Worst Abuses of Debt Compensation*

The previous Sections examined several potential shortcomings of debt compensation. While each shortcoming can be adequately addressed, the advantages of debt compensation can be fully obtained only with competent judicial decision making. Without such judicial capabilities, the risks identified here may transform debt compensation from a powerful new tool for managerial compensation in bankruptcy into a windfall for unscrupulous managers and creditors.[152]

None of the criteria suggested above for judicial approval or rejection of a debt compensation plan appear unworkable. For example, overly generous debt compensation plans should be easy to identify and reject. If the debt compensation percentage is well above the norms for incentive compensation in comparable firms outside of bankruptcy, then the debt compensation plan should be struck down. This standard should prevent the most outrageous and inefficient debt compensation plans from occurring. But what of debt compensation plans that appear high, but still may be defensible? Such debt compensation schemes might be efficient, and it is much harder for judges to determine their value. Until bankruptcy courts have seen a number of debt compensation plans in action, it will be difficult to know whether a plan is value maximizing or not.

Because of this difficulty, bankruptcy courts should adopt a cautious stance with regards to debt compensation plans until they are well established. So long as judges lack experience with debt compensation plans, they should reject any such plan that appears questionable, even if the plan may be value maximizing. As judges grow more comfortable with the mechanics of debt compensation, they can expand the range of approved debt compensation plans in accordance with their practiced judgment.

Cautious adoption of debt compensation offers several advantages. By allowing only modest deviations from the status quo, cautious adoption ensures that debt compensation will not engender any unforeseen disasters, allowing judges to develop some comfort with debt compensation while the stakes are reasonably low. Similarly, cau-

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[152] Even without competent judicial decision making, the chances of such an outcome should be less in the case of debt compensation than in the case of other forms of managerial compensation in bankruptcy. *See supra* Part III.C. For an example of the view held among some scholars that executive compensation more generally is a windfall for unscrupulous managers, see BEBCHUK & FRIED, *supra* note 3, at 137-46.

tious adoption will allow judges to learn which of the potential dangers described above, if any, are relevant in practice while the costs of mistakes are at their smallest. Procedures to address any potential flaws can then be developed. Finally, cautious adoption will enable bankruptcy practitioners to grow comfortable with debt compensation.

The standards for judicial review of debt compensation articulated in this Part, combined with cautious adoption of debt compensation, should enable the realization of the considerable benefits of debt compensation at minimum cost and risk.

CONCLUSION

This Article proposes a new form of incentive compensation in bankruptcy that constitutes an improvement over existing compensation plans and proposals. Granting the unsecured creditors' committee the right to offer debt compensation to managers institutes much better incentives for value-maximizing managerial performance. Debt compensation creates incentives for managers to self-interestedly maximize the value of the firm rather than attempt to protect their own jobs or favor one class of creditors over another. As a result, debt compensation offers a potentially important new method for improving managerial performance during bankruptcy, when managerial performance assumes a more critical role. Debt compensation comes with some pitfalls, however. For debt compensation to realize its potential, judges must be vigilant against those attempting to abuse debt compensation for inefficient ends. This task is not intractable, however, and debt compensation's potentially prodigious benefits make the risks worth bearing.

More generally, debt compensation is an example of the potential for CEO compensation to improve bankruptcy performance. Just as scholars of solvent companies place a heavy emphasis on the role of CEO compensation in corporate governance, so too should scholarly attention be redirected toward the subject of compensation in bankruptcy.