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RUNNING THE ASYLUM: GOVERNANCE PROBLEMS IN BANKRUPTCY REORGANIZATIONS

Christopher W. Frost*

INTRODUCTION

Like much of life, the study of bankruptcy is the study of leverage. Chapter 11 of the United States Bankruptcy Code[1] (the "Code" or the "Bankruptcy Code") may be appropriately described as providing a framework within which interested parties may negotiate solutions to the problems facing a troubled company. The allocation of leverage to the negotiating parties is critical to the ultimate outcome of the process. In any negotiation setting, control over the bargaining process is a key item of leverage. This Article proposes a framework for analysis and suggests solutions to the problem of control over corporations during the pendency of a Chapter 11 reorganization case.

The provisions of Chapter 11 distribute negotiating leverage to each of the participants in the process and provide default rules in case of a breakdown in the bargaining. Control over the bargaining process is allocated to the pre-bankruptcy management of the business, through the fictitious institution known as the "debtor in possession."[2] Management's control goes beyond

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1. 11 U.S.C. §§ 1101-1174 (1988).

2. 11 U.S.C. § 1101 defines "debtor in possession" as being the "debtor" unless a trustee has been appointed. The "debtor" is the entity that is the subject of the bankruptcy case. 11 U.S.C. § 101(12) (1988). For most purposes, the debtor in possession can be regarded simply as the pre-bankruptcy corporation with special rights and obligations under the Bankruptcy Code. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984); Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 20-37 (1989) (providing an expanded view of the debtor in possession). Nimmer and Feinberg see the nature of the debtor in possession as being the central question of corporate governance. This Article does not contest this notion. Instead, this paper is intended to expand on the general ideas contained in Nimmer and Feinberg's work by exploring the effectiveness of the duties imposed on the debtor in possession in replacing the governance structures existing outside of the Chapter 11 process.

11 U.S.C. § 1107(a) (1988) provides that the "debtor in possession" has all of the rights, powers, and obligations of a trustee under the Code. Thus, although most of the provisions of the Code refer to the "trustee," they can be read to mean "debtor in possession" in most cases. When such provisions are referred to herein, the author has substituted the term "debtor in possession" where appropriate.

day-to-day operational decisions to reach issues regarding fundamental changes in the asset and liability structure of the company.[3]

Though most of the negotiations in a Chapter 11 reorganization revolve around the development of a plan of reorganization that effects the complete business and financial restructuring of the business, many other substantial issues must be resolved outside of the context of the plan. Bankruptcies take time — often a long time.[4] Given this reality, and the desirability of continuing the operations of the business during the reorganization process, necessity dictates that some strategic decisions be made outside of the plan process. For example, decisions involving the terms and desirability of financing the business operations, the assumption of executory contracts, and the need to sell substantial business assets may need to be reached well before the completion of the plan negotiations.

Often these decisions directly reach the fundamental asset deployment and financial restructuring issues that the plan process is intended to resolve. Unlike the plan process, however, the decisionmaking structure cannot be premised on fully negotiated solutions. Instead, the system must be based, to some extent, on delegation of authority with concomitant monitoring and lines of responsibility.

The management of a bankrupt company enjoys primacy in this decision making scheme for at least two reasons. First, management, by virtue of its past day-to-day control over the operational aspects of the corporation's business, enjoys huge informational advantages. Second, the myriad transactions that must be entered to operate a business during a reorganization all require some central party to carry on at least initial negotiations with the third party involved in the deal. These factors combine to make management perhaps the most powerful group in the bankruptcy process.

The problem of control over business decisions has been the subject of commentary, case law, and statutory development. An entire structure of corporate governance has developed outside of the Chapter 11 process. Outside of bankruptcy, managers are exhorted to act as fiduciaries for the owners of the corporation and are subject to removal through a scheme relying on contract and market forces. The system responds to concerns that managers will hold incentives that may conflict with those held by the owners

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3. The most obvious instance of debtor control over the bankruptcy process is the 180-day period in which the "debtor" has the exclusive right to propose a plan of reorganization. 11 U.S.C. § 1121(b) (1988). This so-called "exclusivity period" enables management to control the negotiations over the plan of reorganization by allowing this group to act as a clearinghouse for the complex web of deals that characterize the process. *See infra* text accompanying notes 28-43. The mere fact that management has the day-to-day authority to operate the business during the pendency of a Chapter 11 proceeding gives rise to more subtle means of control and corresponding leverage that may be of greater moment than the exclusivity period, however. This paper is primarily concerned with management's control over the business during the plan negotiation process.

4. For example, the reorganization of the Johns-Manville Corporation consumed 4.3 years from the filing of the petition initiating the case to the confirmation of the plan of reorganization. *See* Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 176 (1990).

and attempts to insure that managers will act in the best interests of their constituencies.

The need to align managers with owners exists inside of Chapter 11 as well. If anything, the problems addressed by the general corporate governance system are heightened by business failure. Chapter 11 provides a corporate governance structure designed to control the behavior of management during the pendency of the reorganization case. Although Chapter 11's governance system roughly corresponds to that existing outside of bankruptcy, the special needs of the reorganization process severely limit the non-bankruptcy system by eliminating contractual and market controls over management behavior.

The elimination of these controls vitiates much of the non-bankruptcy governance structure's effectiveness and may render owners unable to check management misbehavior during the reorganization. Chapter 11 provides some additional controls in the form of a representational structure and judicial oversight that, in the abstract, could adequately address concerns over managerial incentives. These controls, however, may be effective only in large reorganizations with active owner participation. In cases involving smaller corporations, managerial discretion over significant decisions may be unchecked.

This Article recommends an approach to Chapter 11 decisionmaking that relies heavily upon the teachings of financial economics. When presented with a particular question that cannot be addressed through the plan negotiation process, courts should look to the wishes of the residual owners of the assets and income of the corporation whenever possible. If that group cannot be found or for any reason does not participate in the decisionmaking process, courts should make use of an impartial third party as fact finder and focal point for significant decisions.

In support of this proposition, this Article examines the Chapter 11 corporate governance structure against the general principles informing the non-bankruptcy system. Section I sets the stage with a general description of the goals of Chapter 11, the process of negotiation among the owners of the business, and several business decisions that require particular attention. Section II describes the non-bankruptcy governance structure applicable to corporations that are solvent and to corporations that are failing. Section III describes the changes in this structure necessitated by the reorganization process. Section IV critiques the bankruptcy governance structure in light of principles underlying the non-bankruptcy system and the various theories of the purpose of the reorganization process. Section V concludes with specific recommendations for improvements in the method by which the bankruptcy asylum is run.

I. THE CHAPTER 11 PROCESS — GOALS AND METHODS

For many corporations experiencing total financial failure, governance is not a serious problem. The business operations of the corporation are discon-

tinued and the assets are liquidated under Chapter 7[5] of the Code or under state dissolution statutes.[6] Conflicts between creditors and shareholders are governed by contract, and claimants simply are paid in the order of contractual priority.[7] Any decisions regarding the appropriate method of liquidation will be made by a bankruptcy trustee or state law counterpart under the supervision of a court and with due regard to the claimants' wishes.

Chapter 11 reorganizations begin from a wholly different perspective. On the assumption that keeping the assets intact will preserve "going concern value,"[8] Chapter 11 provides for a continuation of the business operations and a financial restructuring rather than a liquidation.[9] This approach requires a more complex structure for decisionmaking than does a simple liquidation.

Chapter 11 is designed to provide a forum and an impetus for negotiations leading to a complete financial and business reorganization.[10] Successful reorganizations are usually characterized by negotiation rather than litigation,[11] and Chapter 11 fosters negotiation through rules designed to force the parties to operate within the confines of the Chapter 11 case[12] and through default rules that provide the baseline for negotiated solutions.[13]

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5. 11 U.S.C. §§ 701-766 (1988).

6. *See, e.g.*, DEL. GEN. CORP. LAW § 275 (1991).

7. *See, e.g.*, 11 U.S.C. § 726 (1988) (distribution of proceeds of estate). The Code does change the non-bankruptcy priority scheme somewhat. *See* 11 U.S.C. § 507 (1988). Claims of taxing entities are elevated in priority and limited special interest priorities are provided under the Code. For the most part, however, the general non-bankruptcy priorities apply in bankruptcy.

8. The term "going concern value" refers to the value of assets held together and used in a business operation. This value is typically contrasted against "liquidation value," which is generally defined as the value of the assets, sold on a piecemeal basis, less the costs of sale. *See generally* Chaim J. Fortgang & Thomas M. Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1064 (1985). Reorganization policy is driven by the general assumption that going concern value is higher than liquidation value. H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977) ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap."). This assumption bears testing on a case-by-case basis, however, because the excess of liquidation value over going concern value should be taken as an indication that the assets can be put to better use by another owner. Further, defining liquidation value as a piece-meal sale of assets may be entirely inappropriate. Assets could be "liquidated" by sale to a single owner and going concern value could be preserved in that way. *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

9. H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977).

10. "[N]egotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders." *Id.* at 224.

11. *See* LoPucki & Whitford, *supra* note 4, at 137-41; Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (Feb. 1984).

12. The automatic stay, provided in 11 U.S.C. § 362 (1988), prohibits actions to collect debt, enforce judgments, and exercise control over property of the estate. This provision forces the parties to operate within the confines of the case. The automatic stay ensures that the pre-bankruptcy owners will participate in the proceeding by stopping all creditor collection efforts and interference with property of the estate. Because financial problems do not occur overnight, the preference provisions of the Code provide a reach back to bring debts paid on the eve of bankruptcy within the proceeding. These provisions make bankruptcy a truly collective proceeding in which everyone must participate. *See infra* text accompanying notes 150-51.

13. Unlike its predecessor, the Bankruptcy Act of 1898, the Code allows parties to waive the requirements of the absolute priority rule. If negotiations over the allocation of value

The Chapter 11 process addresses the two major concerns facing owners[14] of a troubled company.[15] First, the basic management and economics of the business must be rationalized by confronting the question of whether the business assets are being utilized in the most éfficient manner. Through reflection upon business realities, owners may come to the conclusion that closure and liquidation of the business is warranted, and Chapter 11 provides a means through which this change may be effected.[16] Short of liquidation, however, many other changes may be desirable. Owners may decide that operations should be streamlined through the sale of discrete business units, discontinuation of product lines, or the sale of single, inefficient assets.[17]

The second primary concern the Chapter 11 process addresses is how the claims on,[18] and interests in,[19] the assets of the business should be restructured. The Code allows payment of such claims and interests in cash or other property of the debtor,[20] or in securities of the reorganized entity.[21] Thus, preexisting claims and interests may be reconstituted in a way that is consistent with the new asset structure of the business. Debt or equity claims may be paid in cash, reduced, eliminated, or substantially changed in an effort to develop a financial structure that can be supported by the expected cash flow of the business operations. This aspect of the reorganization process is the more difficult because claimants realize that they are involved in a zero sum game in which dollars won by one group equal dollars lost by another.[22]

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in the company fail, however, the Code imposes a rule of absolute priority. *See infra* text accompanying notes 28-43.

14. This Article uses the term "owners" to include creditors as well as shareholders. The use of the term "owners" to reflect both groups is not merely for convenience. One premise of this Article is that the concept of "ownership" as carrying with it decisionmaking authority is elusive when dealing with an insolvent corporation. We do not know who the "owners" are, so we must assume that everyone has a potential justification for claiming the title. Where necessary to distinguish creditors and shareholders, this Article will use the more specific term.

15. *See* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 104 (1984) [hereinafter *Diverse Ownership Interests*].

16. 11 U.S.C. § 1123(b)(4) (1988) allows the parties to provide for the sale of all or any part of the property of the estate under the plan of reorganization.

17. 11 U.S.C. § 363 (1988) allows the debtor in possession to use, sell, or lease assets after notice and hearing. *See infra* text accompanying notes 66-69.

18. 11 U.S.C. § 101(4) (1988) defines "claim" broadly enough to include all "rights to payment" from the debtor.

19. The term "interest" is not defined in the Code, but it refers to rights under common or preferred shares. *See* 11 U.S.C. § 501(a) (1988) ("An equity security holder may file a proof of interest.").

20. 11 U.S.C. § 1123(a)(5)(D).

21. *Id.* § 1123(a)(5)(J).

22. Negotiations over these two issues involve many competing interests. Concerns over the appropriate deployment of assets obviously affect employees, suppliers, and other dependents of the bankrupt corporation. The Code, at least facially, appears to ignore such interests in favor of the protection of the interests of the actual "owners" of the business. Right or wrong, this bias exists in the Code and, therefore, the analysis of these two questions will revolve around the rights and positions of the owners — at least initially. *See infra* text accompanying notes 278-83 for an analysis of the effect of these other interests on the governance analysis.

Ideally, the two concerns should be addressed separately.[23] The most efficient deployment of assets exists independently of the ownership interests in them. For instance, a corporation selling an obsolete product must put its assets to a different use if it is ultimately to survive. If the assets required to manufacture the product cannot be put to their most profitable use by the reorganizing corporation, they must be sold to another entity — perhaps even a scrap dealer — who can utilize them to their potential. This economic reality is not changed by the fact that a sale of the assets will result in the realization of losses by particular owners of the business.

The ability of one group of owners to manipulate asset deployment in an attempt to obtain more favorable treatment in the financial restructuring may lead to inefficient results. For example, creditors attempting to achieve full payment of their claims may take actions that would result in the liquidation of the business — even when the business should be continued as a going concern.[24] Insuring that the procedure remains collective in nature goes a long way toward controlling this behavior. The automatic stay[25] prohibits individual actions to collect debt and forces pre-bankruptcy owners to act as a single owner would in making decisions regarding the appropriate deployment of business assets.[26]

A collective procedure is not enough to insure rational decisionmaking, however. The system also should allocate authority in a way that requires decisionmakers to bear the costs of their decisions.[27] Without such accountability, a system may lead to strategic decisions designed to benefit only the decisionmakers and not the interested parties collectively. The system also must address pragmatic concerns of speed and efficiency if it is to provide realistic options to the parties. With these goals in mind, the following discussion describes the context in which broad questions of asset deployment and financial restructuring are addressed.

A. The Plan Process

Most of the negotiations in a Chapter 11 case revolve around the development of a plan of reorganization that will set the terms of the restructuring.[28] The plan effects the financial restructuring of the business by classifying claimants and shareholders into groups based on their pre-bankruptcy rights and by providing the terms upon which the members of the classes will be paid.[29] Payment may be made in cash or property, or in new claims against

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23. *See* Douglas G. Baird & Thomas H. Jackson, *Bargaining after the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 787 (1988) [hereinafter *Absolute Priority Rule*] ("Bankruptcy law should ensure that fights about who owns a firm's assets should not undercut efforts to use them in the most beneficial way possible.").

24. *See infra* text accompanying notes 253-55.

25. 11 U.S.C. § 362 (1988). *See supra* note 12 for a discussion of the automatic stay.

26. *See Diverse Ownership Interests*, *supra* note 15, at 105.

27. *See id.* at 108.

28. *See* 11 U.S.C. §1123 (contents of a plan). The plan provides the financial structure of the reorganized entity as well as other provisions that will govern the company as it emerges from the protection of the bankruptcy proceedings. Thus, the plan is the base restructuring instrument and all of the owners are highly interested in its content.

29. *Id.*

the assets of the business.[30] Normally, however, the plan provides that pre-bankruptcy owners will receive new debt or equity claims against the assets of the reorganized business, rather than cash payments.[31]

The plan also may provide for changes in the asset structure of the firm through asset sales,[32] assumption or rejection of executory contracts,[33] and settlement or prosecution of claims owned by the debtor.[34] With few exceptions,[35] the Code allows the parties to strike any bargain they desire.

These negotiations may be aptly characterized as a clash of priorities; owners of differing priorities each seek to maximize their shares of the newly reorganized entity. At the simplest level, bankruptcy conflicts normally will be between creditors and shareholders of the business. As the number of levels of debt and equity increase, however, the situation becomes more difficult. Senior creditors may clash with junior creditors. Junior creditors may argue with subordinated debenture holders. Equity holders may quarrel with everyone. The configurations of alliance and conflict among the various classes of claimants are limited only by the creativity of the participants and the complexity of the firm's capital structure.

At bottom, the difficulties encountered in the negotiations all relate to the question of how to allocate the value of the business assets when it is unclear what that value is. The difficulties of valuing the business, and thus valuing the various instruments under which the parties will continue their ownership in the business, enable each class to assert an entitlement to a continued ownership interest based on their view of the corporation's business prospects.

The Bankruptcy Code encourages and sets the stage for these negotiations. The Code allows class waiver of the right to absolute priority,[36] thereby

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30. *See supra* text accompanying notes 20-21.

31. There are, of course, exceptions. Small creditors are often paid in cash because their claims are too small to merit the issuance of reorganization securities. *See* 11 U.S.C. § 1122(b) (1988). Also, 11 U.S.C. § 1123(b)(4) permits liquidating plans in which the assets of the business are sold and the proceeds distributed.

32. *Id.* § 1123(a)(5)(D); § 1123(b)(4).

33. *Id.* § 1123(b)(2).

34. *Id.* § 1123(b)(3).

35. When all of the owners agree to a course of action, the restrictions imposed on the reorganized business are no greater than the legal restrictions imposed upon corporations operating outside of bankruptcy. *See* 11 U.S.C. § 525(a) (1988) (prohibition on discrimination by governmental units against persons who have been debtors). Of course, the business must comply with laws generally applicable to business operations. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 152-53 (1986).

Chapter 11 contains provisions allowing a super-majority to bind all of the owners to a particular course of action. *See infra* text accompanying notes 36-39. Where less than all of the creditors have agreed to a course of action, dissenting creditors are protected by the "best interests of the creditors" rule contained in 11 U.S.C. § 1129(a)(7) (1988). This rule requires the parties to allocate to the dissenting creditors at least what they would have received in a liquidation of the business under Chapter 7.

36. The absolute priority rule was developed in the early part of this century in equity receivership cases. Generally, the rule requires each class of creditors to be paid in full in cash or in reorganization securities prior to receipt or retention by any junior class of any property or interest in the reorganized business. Northern Pac. Ry. v. Boyd, 228 U.S. 482, 505-08 (1913). A corollary to the rule is that senior claims may not receive compensation in cash, prop-

allowing junior owners to continue their ownership of the post-bankruptcy business, even when the plan fails to compensate senior classes fully for their prepetition claims. If plan negotiations fail to secure approval of all classes of claims and interests, however, the absolute priority rule restricts the ability of junior classes to continue their ownership of the business unless senior classes are paid in full.[37]

The absolute priority rule provides a default rule against which the court must measure the plan's allocation of value. This process, known as "cramdown," requires the court to value[38] the business enterprise, thereby valuing the reorganization securities issued under the plan. These values then must be measured against the owners' non-bankruptcy priorities to ensure that the plan allocates reorganization securities to the owners in accordance with those priorities.[39]

Obviously this is a complex determination.[40] It is also fraught with uncertainty and risk.[41] In fact, the rule is so complex that its elimination (except as a default rule operating only in the event of a breakdown in negotiations) was one of the central features of the Bankruptcy Reform Act of 1978.[42] The Chapter 11 process wisely leaves the fundamental decisions regarding asset deployment and financial restructuring to those economically interested in the business.[43] In so doing, the bankruptcy system generally

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erty, or reorganization securities in an amount greater than their prepetition claims. *See* Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979) [hereinafter *Cram Down I*]. The absolute priority rule was significant in large reorganizations under Chapter X of the Bankruptcy Act of 1898. *See, e.g.*, Case v. Los Angeles Lumber Prods. Co., Ltd., 308 U.S. 106, *reh'g denied*, 308 U.S. 637 (1939); Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950).

37. The absolute priority rule is codified at 11 U.S.C. § 1129(b) (1988). This section, however, applies only in the event that an otherwise confirmable plan fails to obtain the acceptance of each class of claims or interests. *See id.* § 1129(a)(8). 11 U.S.C. § 1126(c) (1988) provides that a class of claims is deemed to have accepted the plan if the plan is accepted by class members holding two-thirds of the amount of claims in the class and one-half of the number of claims in the class. 11 U.S.C. § 1126(d) provides a similar rule for acceptance of claims by interest holders, but eliminates the one-half in number requirement.

38. The widely accepted valuation method is the capitalization of future earnings. *See* Consolidated Rock Prod. Co. v Du Bois, 312 U.S. 510, 525 (1941). Using this method, the court must determine the likely cash flow of the business over the foreseeable future and discount that cash flow back to present dollars at a discount rate that reflects enterprise risk. Errors in either variable may impact greatly the ultimate valuation. The process has been described as "a guess compounded by an estimate." H.R. REP. NO. 595, 95th Cong., 1st Sess. 222 (1977).

39. For an excellent discussion of cramdown in all of its various forms, see *Cram Down I*, *supra* note 36; Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990) [hereinafter *Cram Down II*].

40. For an example of the complexity of a cramdown determination, see *In re* Jartran, Inc., 44 B.R. 331 (Bankr. N.D. Ill., E.D. 1984).

41. *See* Nimmer & Feinberg, *supra* note 2, at 3-6.

42. H.R. REP. NO. 595, 95th Cong., 1st Sess. 222-24 (1977).

43. The ability of a super-majority of class members to bind dissenting members to a plan that does not comport with absolute priority should increase the chance that the rule will be waived when it is rational to do so. *See generally* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987). By eliminating the ability of each creditor to withhold approval of an economically sound plan as a strategic ploy for better treatment, the Code opens the negotiating process to a wider range of possible distributions recognizing a wider variety of

satisfies both the economic and pragmatic concerns stated earlier. Owners, rather than judges, decide how to deploy the assets of the corporation and how to divide their value.

B. Non-Plan Decisions and Transactions

Though most of the Chapter 11 process focuses on developing a plan of reorganization, many decisions must be reached during plan negotiations to keep the business operations afloat. These questions involve more than the simple day-to-day operation of the business, however. They reach the broader asset deployment and financial restructuring issues that are at the heart of the entire process. The following discussion looks at three such decisions: financing the debtor in possession, the assumption or rejection of executory contracts, and the sale of assets of the estate.

1. Postpetition Financing

The filing of a Chapter 11 petition often gives rise to a need for cash approaching crisis proportions. Trade financing may become unavailable as nervous creditors insist on cash on delivery instead of their normal trade terms.[44] If the business operations are to continue, employees must be paid and supplies must be purchased. Added to these problems is the lack of free cash in today's highly leveraged business environment. Under contemporary commercial finance practices, lenders often hold security interests in substantially all of the cash of their borrowers.[45] Secured creditors with an interest in cash collateral are protected against dissipation of the cash in the operation of the business.[46] Thus, one of the first priorities in many cases is to secure a source of financing.

The Code authorizes the debtor in possession to incur indebtedness in the ordinary course of business.[47] Postpetition creditors are entitled to

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contributions and values. For example, under the Code, manager-shareholders may negotiate for continued participation in the reorganized company on the basis of their skill in operating the business even if the value of the business is not high enough to allow them to participate on account of their pre-bankruptcy interests. If managers do, indeed, provide such value, senior classes likely will recognize the contribution and provide a continued ownership interest in the business as compensation. *See Absolute Priority Rule*, *supra* note 23, at 747-60. Managers may not, however, force the senior classes to compensate them for such contribution. *See* Norwest Bank Worthington v. Ahlers 485 U.S. 197 (1988), *on remand*, *In re* Ahlers, 844 F.2d 587 (1988).

44. *See, e.g.*, Bryan Doherty, *Factors Toughen Stand on Campeau*, WOMEN'S WEAR DAILY, Jan. 17, 1990, at 1 (describing concerns of vendors to Federated and Allied department stores immediately after these corporations filed Chapter 11 petitions).

45. Creditors relying on a security interest in a debtor's inventory and accounts receivable normally require the obligors on the accounts to make payments to a "lock-box" or "blocked account" under the control of the lender. This procedure is necessary to insure that the lender retains a priority in the cash proceeds of the accounts. *See* D. Benjamin Beard, *The Purchase Money Security Interest in Inventory: If It Does Not Float, It Must Be Dead!*, 57 TENN. L REV. 437, 471 n.170 (1990); JAMES J. CUNNINGHAM ET AL., STRUCTURING SECURED COMMERCIAL LOAN DOCUMENTS § 6.05 (1991).

46. 11 U.S.C. § 363(c)(2) (1988) (debtor in possession may not use, sell, or lease cash collateral unless the secured creditor consents or the court approves).

47. 11 U.S.C. § 364(a) (1988) (debtor in possession may obtain unsecured credit and unsecured debt in the ordinary course of business).

administrative priority for such extensions of credit.[48] This authority takes care of normal trade credit to the extent it remains available after the petition is filed. If such trade credit is not forthcoming, however, the debtor must seek financing from other, non-ordinary, sources.

The Code provides a scheme of credit enhancements in order to induce lending.[49] Case law provides additional enhancements directed at the debtor's existing secured creditors.[50] In the event an administrative priority is not enough to convince a potential lender to make a loan to the debtor, the Code allows the debtor to grant security to the potential lender.[51] If financing is unavailable on this basis, the existing secured lender may be willing to make a loan or allow the use of cash collateral[52] in exchange for an enhancement of its prepetition position through a device known as cross-collateralization.[53]

Cross-collateralization allows a secured creditor to reduce or eliminate prepetition collateral shortfalls by taking a security interest in property acquired postpetition to secure both pre- and postpetition advances. Absent such a provision, the interest securing a lender's prepetition claim will not extend to property generated by business operations after the petition is filed.[54] Instead, the lender will share this postpetition property with non-subordinated unsecured creditors on a pro-rata basis.[55] Thus, cross-collateralization can be viewed as an incremental direct cost of financing because it reduces assets available to the general unsecured creditors.[56] Such costs in fact may be

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48. *Id.* Debt or credit obtained in the ordinary course of business is an administrative expense allowable under § 503(b)(1).

49. After notice and a hearing, the court may authorize the debtor in possession to incur debt with a priority over other administrative expenses or secured by a lien on property of the estate. *See* 11 U.S.C. § 364(c). If all else fails, 11 U.S.C. § 364(d) allows the court to authorize a so-called "priming lien"— a lien senior to those of existing secured creditors — provided that the existing secured creditors are adequately protected.

50. *See infra* text accompanying notes 53-58.

51. 11 U.S.C. § 364(c)(2) (The court may allow the debtor in possession to incur debt secured by a lien on property of the estate.).

52. The debtor must obtain either the consent of the secured creditor or bankruptcy court approval prior to using "cash collateral." 11 U.S.C. § 363(c)(2).

53. *See, e.g., In re* Vanguard Diversified, Inc., 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983); *In re* Roblin Indus., Inc., 52 B.R. 241, 244 (Bankr. W.D.N.Y. 1985); *In re* FCX, Inc., 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985). *But see In re* Monach Circuit Indus., Inc., 41 B.R. 859, 862 (Bankr. E.D. Pa. 1984) (cross-collateralization constitutes a preference under § 507(b) and is, therefore, impermissible); *In re* Tenney Village Co., 104 B.R. 562 (Bankr. D.N.H. 1989) (financing agreement containing cross-collateralization provision violated debtor's fiduciary obligations to estate).

Cross-collateralization is but one of several credit enhancements available to the debtor in possession. Other such enhancements include cross-super-prioritization and waiver clauses. *See* Charles J. Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 85-92 (1991) [hereinafter *Emergency Preferential Orders*].

54. 11 U.S.C. § 522(b)(2)(B) (1988) (Property acquired after commencement of the case is not subject to any lien created prior to the commencement of the case.).

55. 11 U.S.C. § 506(a) (1988) (A claim is secured to the extent of the value of such creditor's interest in the estate's interest in such property and is unsecured to the extent that the value of the creditor's interest is less than the amount of the claim.).

56. *See* JACKSON, *supra* note 35, at 168; Charles J. Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109, 169-74 (1986) [hereinafter *Cross-Collateralization*]. For example, assume that a lender has a $100,000 claim secured by accounts receivable worth $75,000 as of the petition date. The debtor requests that the lender

justified if no other lender is willing to finance the debtor in possession on a cheaper basis and if the value preserved from the operation of the business is greater than such costs.[57]

The decision to finance on this basis implicates both asset deployment and financial restructuring issues. The need for financing implicitly assumes both that it is more beneficial to keep the business assets together and operating than it is to liquidate those assets, and that the costs of financing are justified by the going concern value saved. The cost of financing under cross-collateral terms changes the ultimate terms of the financial restructuring by expanding the reach of the secured creditor's prepetition priority. By expanding the assets in which the secured creditor may claim priority under the absolute priority rule, the term may provide a significant increase in the secured creditor's leverage in the plan process.[58]

2. Executory Contracts

A contract is deemed to be executory under the Code when some performance is due on both sides of the transaction.[59] Professor Douglas Baird and Dean Thomas Jackson have aptly described executory contracts as an asset coupled with a liability — the asset being the performance due the debtor and the liability being the obligation owed by the debtor.[60] Since bankruptcy law views assets as carrying with them all of their restrictions and liabilities,[61] the Code's handling of these special creatures follows neatly. The Code allows the debtor in possession to assume the contract or to reject the contract.[62] If the debtor chooses to assume the contract, the debtor must take with it all of the burdens of that assumption — namely the requirement of full

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provide $50,000 of postpetition financing and offers the lender a lien on accounts acquired by the debtor postpetition that are anticipated to have a value of $75,000 by the end of the case. To the extent that the lender insists upon, and the debtor agrees to, cross-collateralization, the postpetition accounts will be pledged to secure both the $50,000 postpetition advance and the $100,000 prepetition obligation. Thus, the lender will, through cross-collateralization, convert its prepetition obligation from an undersecured claim to a fully secured claim. This conversion results in financing costs borne by the unsecured creditors who otherwise would have been entitled to satisfy their claims out of the postpetition accounts on a pro-rata basis with the secured creditor.

57. *See* JACKSON, *supra* note 35, at 168.

58. Cross-collateralization is a species of the broader issue of whether any claimant should be allowed to receive payment of its prepetition claim in return for necessary postpetition goods and services. The "doctrine of necessity" was developed in railroad reorganizations as a means of allowing the bankrupt railroad to obtain needed supplies from creditors who insisted on payment of their claims as a prerequisite to continuing to do business with the debtor. *See generally Emergency Preferential Orders*, *supra* note 53; Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1 (1989). These payments operate in the same manner as cross-collateralization in that they use estate assets to change pre-bankruptcy priorities.

59. Professor Countryman has developed what has since become the traditional definition of an executory contract: "[A] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1972).

60. DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 234 (2d ed. 1990).

61. *Id.* at 217-18. *See also* Board of Trade v. Johnson, 264 U.S. 1 (1924).

62. 11 U.S.C. § 365(a) (1988).

performance of all of the debtor's obligations under the contract.[63] If the debtor rejects the benefit under the contract, the contract is simply treated as having been breached by the debtor and the damages occasioned by that breach are treated as would any other prepetition claim.[64]

The decision to accept or reject an executory contract raises an asset deployment issue. For instance, assume that a debtor wishes to continue a line of business that requires an exclusive trademark license. If the license is already held by the debtor as a right under an executory contract, the debtor may continue to use the right through assumption of the contract and payment of all outstanding obligations owed under the contract. The business issue presented is whether to use estate assets in order to continue as licensee. This decision is no different from the initial decision to purchase the license.[65] The decisionmaker must weigh the purchase price — payment of the prepetition obligation — against the expected benefit provided by the license. This decision also impacts the financial restructuring question by removing the non-bankrupt party from the restructuring negotiations through payment in full.

3. Asset Sales

One of the most fundamental questions that participants in a Chapter 11 reorganization may face is whether significant business assets should be sold outside of the plan process.[66] The need to sell assets prior to the completion and approval of a plan arises from the fact that the plan process has nothing to do with the process of marketing assets. Plan negotiations are messy and relatively protracted affairs. Alliances among owners and views over the appropriate disposition of corporate assets may change frequently. Most of the problems addressed by the process do not concern the prospective buyer of assets who simply wishes to close the purchase with a minimum of transaction costs. Thus, owners of companies undergoing a Chapter 11 reorganization often have found it useful to sell assets before the conclusion of the Chapter 11 process. The Code recognizes this business reality and provides authority for these transactions.[67]

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63. *Id.* § 365(b)(1).

64. *Id.* § 365(g).

65. This discussion assumes that the contract rights owned by the debtor are useful in the business operations. The Code also provides that the debtor in possession may assume favorable executory contracts and assign them to third parties. *Id.* § 365(f). When the debtor in possession wishes to assign contractual rights in this manner, the cost-benefit issues surrounding the assumption are normally simplified. Costs can be determined by looking to the debtor's obligations and benefits can be determined by looking to the consideration the third party is to pay to the estate. The only question remaining is whether the estate is better off with the cash than with the contractual rights — an asset sale question. *See infra* text accompanying notes 66-69 for an analysis of asset sale questions.

66. This issue has arisen in several large reorganizations. *See, e.g., In re* Continental Air Lines, Inc., 780 F.2d 1223 (5th Cir. 1986) (ability of debtor to enter into long-term, post-petition leases of property of the estate); *In re* Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983), *reh'g denied*, 705 F.2d 450 (5th Cir. 1983) (sale by debtor of all of its assets); *In re* Lionel Corp., 722 F.2d 1063 (2d Cir. 1983) (sale of 82% of debtor's common stock holdings in another corporation).

67. 11 U.S.C. § 363(b)(1) (after notice and a hearing, the trustee may use, sell or lease property outside of the ordinary course of business).

The effect of such sales on the asset deployment question is obvious. The pre-plan sale of a significant asset is the deployment decision. If the company decides to sell assets, this decision should be reached because the business is better off with the cash than with the particular assets. The sale also affects the financial restructuring issue because it removes the asset from the debate over business value.[68] The sale normally converts the property sold, the value of which may be debatable, into cash, the value of which cannot be contested.[69] Thus, to a certain extent, the negotiations over the appropriate division of business values will be simplified by the sale.

Financing, executory contracts, and asset sales all share a common theme. They are all fundamental business decisions that directly impact the basic problems Chapter 11 is designed to address; however, given the need to efficiently operate the business during the plan process, these issues may often be decided without a full negotiation process culminating in a vote by interested parties. The plan negotiation mechanism is normally unavailable or unsuitable to respond to these issues because of its length and fractious nature. Full participation of claimants must give way to pragmatism in the interest of preserving some value to which their claims may attach.

This practical concern gives rise to a need to control the group that makes or initiates these decisions. Since those economically interested in these significant decisions may not fully participate in the decisionmaking process, some mechanism must be available to insure that the decisionmaker acts in the interests of the group affected by the decisions. This problem is exactly what governance systems are designed to resolve. The key is designing a governance structure that aligns the incentives of the representatives with those of the represented.

II. NON-BANKRUPTCY CORPORATE GOVERNANCE PRINCIPLES

Of course, governance problems are not unique to Chapter 11. Corporate owners face the same problems of incentive alignment outside of Chapter 11 as they do within the process. The non-bankruptcy corporate governance system consists of a web of contract, market, and legal devices that together provide an integrated framework for the resolution of conflicts among corporate actors. A few general notions are commonplace. If a corporation is solvent,[70] its management operates the business on behalf of the shareholders. Shareholders hold ultimate decisionmaking authority through

68. The sale of an asset in which a creditor has a security interest more directly affects the financial restructuring question. 11 U.S.C. § 363(f) provides that assets may be sold free and clear of liens if the secured creditor is given the proceeds of the sale or if the secured creditor's lien continues in the proceeds. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977). Thus, a sale of an asset that serves as collateral removes the secured creditor from the negotiations to the extent of the value of that asset.

69. Of course, if the sale were made for noncash consideration, a note for example, the debate over value would continue. The focus of the valuation simply would shift to the proceeds.

70. "Solvency" is used herein to refer to the value of the corporation's assets as compared to the amount of its liabilities. Thus, a corporation is "solvent" when the value of its

their ability to change the composition of the corporation's board of directors. The creditors' place in the governance system is primarily derived from contractual protections.

As the corporation begins the slide toward insolvency and failure, creditors' contractual protections begin to operate as control devices, allowing creditors to exercise more of the decisionmaking authority previously left to shareholders. This section looks at these general principles in the context of solvent corporations and corporations experiencing financial distress in an attempt to develop a framework under which the bankruptcy governance system may be analyzed.

A. Governance in the Solvent Corporation

Economic theory views the corporation[71] as the central party to a set of contracts under which factors of production are combined.[72] Owners of labor, raw materials, and capital each contract with the corporation rather than with each other,[73] thus reducing overall transaction costs and encouraging "cooperative specialization"[74] of input owners. Each individual contracting party makes initial decisions based upon the party's view of the proffered contract terms. The process of bargaining provides decisionmaking authority to those most affected by the decisions; and, if not for the high costs associated with contracting, parties likely would prefer the contractual model to any representational decisionmaking system.

Governance, then, is a decisionmaking structure necessitated by the inefficiencies associated with contracting for all contingencies. Because bargaining is costly, some group must hold discretion over the decisions that fall between the gaps of contract. Corporate statutes vest this discretion in the corporation's board of directors, and the board further delegates much of its authority to the corporation's officers.[75] The board and officers, herein collectively referred to as the "management," thus have the discretion to make business decisions and are charged with monitoring the actions of all of the contracting parties to insure that they are fulfilling their bargains.

The analysis cannot end here, however. Management itself must be controlled lest it fail to uphold its responsibility to operate the business in an

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assets exceeds the amount of its liabilities and is "insolvent" when its liabilities exceed the value of its assets. *See* 11 U.S.C. § 101(29) (1988).

71. Economic analysis uses the broader concept of the "firm." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976). Corporations are one type of firm. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 787 (1972).

72. Jensen & Meckling, *supra* note 71, at 308; Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302 (1983) [hereinafter *Separation of Ownership and Control*].

73. The alternative method of organization is through markets. *See* Alchian & Demsetz, *supra* note 71, at 777.

74. *Id.*

75. DEL. GEN. CORP. LAW § 141 (1991); REV. MODEL BUS. CORP. ACT §§ 8.01, 8.25 (1991). For simplicity, the board and the officers will be referred to collectively as the "management."

efficient manner. To whom is management accountable? The answer to this question yields the true locus of discretionary authority — the shareholders of the business.

1. Shareholders and Managers: The Importance of Residual Claims

It is widely assumed that shareholders, as opposed to creditors, employees, suppliers, or the state, hold ultimate control over the management of the business and, thus, over discretionary decisions affecting the corporation.[76] The shareholders elect the corporation's board of directors[77] which, along with the corporation's officers, owes a duty of loyalty and a duty of care to the shareholders.[78] Other parties are simply protected by specific contractual or legal rules.

This division of authority can be explained by an examination of the nature of the shareholders' contract with the company. Because shareholders hold claims to residual earnings of the company, they hold the correct set of economic incentives to monitor management to ensure that it makes decisions that will maximize the value of the assets of the business.[79] The nature of residual claims is such that the group holding such claims is the primary beneficiary of successful business operations and bears most of the risk of poor performance. No other group holds such incentives.[80]

Shareholders in public corporations cannot, and do not want to, make all of the decisions falling between the gaps of contract, however.[81] The high

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76. This assumption is not self-explanatory. *See* Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983) [hereinafter *Voting*]. Although it is clear that someone needs to retain final discretionary authority, it is not as clear that this group should or must be the shareholders. *See, e.g.*, DEL. GEN. CORP. LAW § 221 (1991) (every corporation, in its certificate of incorporation, may give its creditors the power to vote).

77. DEL. GEN. CORP. LAW § 211 (1991); REV. MODEL BUS. CORP. ACT §§ 8.03, 8.04 (1991).

78. DEL. GEN. CORP. LAW § 144 (1991); REV. MODEL BUS. CORP. ACT § 8.42 (1991). *But see*, Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 265-73 (1988) (arguing that creditors should be owed such duties).

79. *See Voting, supra* note 76, at 403; Alchian & Demsetz, *supra* note 71, at 782.

80.

> As the residual claimants, the shareholders are the group with the appropriate incentives (collective choice problems to one side) to make discretionary decisions. The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.

Voting, supra note 76, at 403.

Williamson, *supra* note 76, at 1210, also points out that because a shareholder's relationship with the firm does not come up for periodic renewal and because a shareholder's investments are not associated with specific assets, a shareholder is unable to protect him or herself by specific contracting in the way that creditors can. *See infra* text accompanying notes 111-24 for a description of creditor protections.

81. Corporate democracy must of necessity be representational. *See* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700

information costs in the complex corporate enterprise coupled with the small stake of each individual shareholder limit corporate democracy to a representational system.[82] With ownership spread among many investors, each individual investor may be unwilling to expend the time and money necessary to obtain information appropriate to the decisionmaking process.[83] Some delegation of authority is therefore necessary.

Most of the shareholders' decisionmaking authority is vested in the board of directors through the articles of incorporation and state corporation codes.[84] Discretion over several significant issues is, however, retained by the shareholders.[85] The reasoning behind this retention of control is again related to the fact that shareholders,[86] as residual claimants, have the most to gain or lose by these decisions.[87]

This delegation of authority requires a system to regulate the relationship between managers and shareholders.[88] The traditional conception of the relationship is that of fiduciary-beneficiary. Management is considered to hold

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(1982) [hereinafter *Corporate Control Transactions*]. Portfolio theory provides that investors may reduce their potential losses by investing in many different companies. *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 17-20 (1986); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 329 (1983) [hereinafter *Agency Problems*] ("Common stock allows residual risk to be spread across many residual claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims.").

The ability of investors to diversify also lowers the cost of capital to the corporation. *See* Alchian & Demsetz, *supra* note 71, at 787 ("For the most part, capital can be acquired more cheaply if many (risk-averse) investors contribute small portions to a large investment."). Thus, the desire for diversification creates a separation of ownership and control. *See* Fama, *supra* note 81, at 290; *Corporate Control Transactions*, *supra* note 81, at 701.

82. *See Separation of Ownership and Control*, *supra* note 72, at 306.

83. *See Voting*, *supra* note 76, at 397. Furthermore, significant free-rider problems may cause even individual investors with a high incentive to become informed to fail to obtain the necessary information. Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 60 (1982).

84. Some commentators view these state corporation codes as simply a "standard form contract" providing "off the rack" rules in order to reduce bargaining costs. *Voting*, *supra* note 76, at 401.

85. Shareholders retain discretion over fundamental changes in the corporation, such as mergers (DEL. GEN. CORP. LAW § 251 (1991); REV. MODEL BUS. CORP. ACT § 11.01 (1991)), the sale of substantially all of the assets of the corporation (DEL. GEN. CORP. LAW § 271 (1991); REV. MODEL BUS. CORP. ACT §§ 12.01, 12.02 (1991)), and changes to the articles (DEL. GEN. CORP. LAW § 109 (1991); REV. MODEL BUS. CORP. ACT § 10.03 (1991)).

86. Decisions over fundamental changes in the corporation also may affect creditors and other suppliers of inputs to the corporation. These parties ultimately may have a "vote" on these fundamental changes through their own contracts with the corporation. Covenants against such changes will require the corporation's management to obtain these parties' consent — their "vote."

87. *See Voting*, *supra* note 76, at 403. Another reason for the requirement of a shareholder vote on changes to the articles of incorporation is that the articles constitute the fundamental contract between the management and the shareholders. As such, shareholders should be entitled to vote on modifications to this document.

88. As the foregoing discussion indicates, the primary focus of corporate governance law is on the relationship between manager and shareholder as opposed to creditors. Creditors, however, also fit into the framework of governance because at some level corporate decisionmaking may cause them to become residual claimants. *See infra* text accompanying notes 111-24.

its powers in trust for the shareholders.[89] This conceptualization of the relationship leads to a governance structure that centers on the duties of loyalty and care[90] that management owes to shareholders.

The problem with the fiduciary model of corporate governance is that it does not adequately explain the true dynamics of the manager-shareholder relationship. As with any relationship involving the delegation of authority, the corporate governance system must address two general problem areas. First, the system must control actions by the management that involve a direct conflict of interest. Shareholders must be assured that management will act without the taint of self-dealing if delegation is to be encouraged. Second, the system of governance must insure that management will act with diligence and care. This latter problem implicates more subtle conflicts which may be present but cannot be discerned by judicial authority and that, therefore, must be controlled by contractual incentives and market forces.

A view of corporate governance that focuses on fiduciary duties works relatively well to explain sanctions against obvious managerial misconduct. The duty of loyalty imposes a high standard of judicial review of management decisions involving some direct conflict of interest.[91] The standard applies, however, only in situations in which a clear conflict is present. When the conflicts are not as clear, judicial abstention is the rule.[92]

Managerial decisions and performance outside of the realm of direct conflict are reviewed only under the business judgment rule.[93] The rule reflects an attitude of abstention by presuming that management's actions were fully informed and in good faith believed to be in the best interests of the company.[94] In abstaining from review of the quality of decisions, courts likely are recognizing the limitations of judicial fact-finding.[95] Conflicts of interest may be present in many corporate decisionmaking settings; but the conflict may be so subtle that a court cannot accurately determine whether management was motivated in its actions by its own interest or the best interest of the company.

Something more than a simple fiduciary-beneficiary model is necessary to explain the resolution of these subtle conflicts within the manager-shareholder relationship. The neoclassical economic analysis of the firm provides a more inclusive theory. This analysis views shareholders and managers as principals and agents, respectively.[96] The principal-agent relationship is

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89. *See* Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233, 250 (5th Cir. 1988); ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 247-76 (1948).

90. *See* ROBERT C. CLARK, CORPORATE LAW 93-141 (1986).

91. *See* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1364-65 (1989).

92. *Id.* at 1358-59; Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1195-97 (1981) [hereinafter *Responding to a Tender Offer*].

93. Palmiter, *supra* note 91, at 1358.

94. *See* CLARK, *supra* note 90, at 123-24.

95. *Responding to a Tender Offer*, *supra* note 92, at 1196.

96. Jensen & Meckling, *supra* note 71, at 308-09; *Agency Problems*, *supra* note 81, at 331.

governed primarily by contract — with fiduciary duties as gap-filling rules.[97] Seen in this light, fiduciary duties are merely a component of a broader contractual framework regulating the relationship[98] rather than an all-encompassing solution to the problems created by the delegation of authority.

The neoclassical analysis starts with the proposition that the interests of managers and shareholders in a public corporation are potentially in conflict. Managers, as utility-maximizing individuals, may have an incentive to shirk, thus giving rise to agency costs including the costs of monitoring managerial behavior and inefficiencies resulting from restraints on management discretion.[99]

Management shirking goes beyond the problem of inattention to the business operations. The problem also extends to attitudes toward risk.[100] In a solvent corporation, management is likely to be more risk averse than are the shareholders. Assuming that the investors in the business hold diversified portfolios of investments, most of the enterprise risk of failure of a particular corporation within the portfolio may be diversified away, leaving shareholders with little risk aversion.[101] Management, on the other hand, has a high level of firm-specific skills invested in the business and is, therefore, unable to diversify.[102] Thus, management likely will avoid decisions that will increase the risk of failure of the corporation but are desired by the shareholders.

The fiduciary principle cannot adequately regulate this type of conflict. Allowing a court to review all management decisions under a strict standard would create an explosion of litigation in which courts would be called upon to make fine judgments regarding the appropriate level of risk the business should be allowed to assume. Abstention is necessary.[103]

Thus, the system requires other controls against shirking. One method of control is through contract. Shareholders retain the ability to displace management through the periodic election of the board of directors.[104] Restraints

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97. This Article expresses no view as to whether these duties, like other contractual duties, ought to be susceptible to waiver by the parties.

98. "The structural rules and the fiduciary principle together cover only the outlines of the relations among corporate actors." *Voting*, *supra* note 76, at 401-02.

99. *See* Jensen & Meckling, *supra* note 71, at 308-10. The reduction of these costs is the central goal of the corporate governance framework. *Responding to a Tender Offer*, *supra* note 92, at 1169-74; *Agency Problems*, *supra* note 81, at 327-28.

100. Coffee, *supra* note 81, at 17-20.

101. *See supra* note 81.

102. Coffee, *supra* note 81, at 19-20.

103.

> Fiduciary regulation (like any other regulation) can also impose costs greater than the agency costs it saves. Agency costs already constrained by internal governance structures and market forces may not require further fiduciary regulation, particularly if that regulation (largely enforced through derivative litigation) would create additional costs of its own. Judicial abstention under the care regime is justified to the extent that these constraints operate effectively. Only when they insufficiently constrain agency costs, such as when self dealing occurs, is judicial intervention demanded.

Palmiter, *supra* note 91, at 1371. *See also Responding to Tender Offers*, *supra* note 92, at 1196.

104. *See supra* note 76 and accompanying text.

provided by the market work alongside the contractual controls. Managers who fail to maximize the value of the corporation's shares may find themselves displaced in a hostile takeover.[105] These controls along with fiduciary duties provide an integrated system of governance. Each aspect of the structure complements the others, and all are necessary to provide a complete system.

Consider first the contractual controls. Standing alone, the ability of individual shareholders to elect directors is relatively meaningless in the large modern corporation. As Adolph Berle and Gardiner Means pointed out over forty years ago, management controls the machinery of election.[106] The proxy machinery is necessary to solve the collective action problems caused by widely dispersed ownership; but since managers control the proxy machinery, they control the outcome of the election.[107]

If the problem is dispersion of votes, the remedy is aggregation of voting power. This is the role of the market. The shareholders' ability to exit the firm by selling their shares creates a concomitant ability to aggregate power through the purchase of shares. If managers shirk, disgruntled shareholders are likely to sell — driving down the price of the shares to a level at which aggregation by a "raider" becomes attractive.[108] Once shares are aggregated, the raider may use the contractual rights accompanying the shares to displace current management.[109]

Fiduciary principles can do nothing more than fill in the gaps by providing sanctions against management actions which are not likely to be adequately restrained by market and contractual controls. Markets may react to

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105. *See generally* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET 119-59 (1988); *Responding to Tender Offers*, *supra* note 92, at 1169-73; Alchian & Demsetz, *supra* note 72, at 788; Richard E. Cook, *What the Economics Literature has to Say about Takeovers*, *in* PUBLIC POLICY TOWARD CORPORATE TAKEOVERS (Murray L. Weidenbaum & Kenneth W. Chilton eds., 1988).

106. BERLE & MEANS, *supra* note 89, at 207-19. Individuals holding stock that is widely dispersed have no real ability acting alone to effect changes. *Responding to Tender Offers*, *supra* note 92, at 1169-71; Lucian A. Bebchuk & Marcel Kahan, *A Framework For Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1079-82 (1990). Also, as pointed out above, shareholders are likely to be rationally indifferent to changes in management because their individual stake in the corporation is relatively small as compared to the costs of organizing all of the shareholders into a cohesive group with enough clout to displace managers. *See supra* text accompanying notes 81-83.

107. BERLE & MEANS, *supra* note 89, at 207-19. Proxy contests seem to be staging a comeback as a means of displacing managers. *See* Bebchuk & Kahan, *supra* note 106, at 1075; Judith H. Dobrzynski, *Shareholders Unfurl Their Banner: Don't Tread on Us*, BUSINESS WEEK, June 11, 1990, at 66 (In 1990, "[m]ore investor groups were waging more proxy fights for outright corporate control or for board representation than ever before."). The proxy rules still, however, make it difficult for shareholders to utilize this mechanism effectively without significant vote aggregation. *See* Bebchuk & Kahan, *supra* note 106, at 1082.

108. Management shirking gives rise to agency costs that can be reduced by an outsider's purchase of a control block and improvement of management. *See Responding to Tender Offers*, *supra* note 92, at 1173.

109. *Id. See also* Alchian & Demsetz, *supra* note 71, at 788.

diversions of assets and to interested transactions, but this reaction may be inadequate to dissuade management from such misbehavior.[110]

2. Creditors and Shareholders: Owners in Conflict

So far the analysis has focused on the relationship between the shareholders and managers. Creditors,[111] as contributors of "sunk" capital,[112] also may be concerned with managerial shirking and misappropriation. Unless such actions threaten the solvency of the corporation, however, shareholders may have better incentives to control these problems. Of more immediate concern to creditors are transactions that benefit the shareholders by increasing the risk of the enterprise after the creditors' capital is committed.

The relationship between corporate shareholders and creditors is inherently characterized by conflict. The competing claims on the corporate income stream result in differing and conflicting incentives.[113] After the interest rate of the debt is set, shareholders may have an incentive to increase the risk of the enterprise and bondholders will wish to see the risk of the enterprise decreased.[114]

The conflict can be described in terms of the phenomena of "other people's money." Bondholders are compensated for their contribution of capital to the corporation through an interest rate that takes into account the risk of nonpayment. This risk, in turn, is directly tied to the overall risk of failure of the corporation. Once this rate is fixed, shareholders will opt for increased risk since the potential gains are captured by them, while losses are shared with the creditors. Unless creditors are able either to control such behavior or

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110. *See Responding to Tender Offers*, *supra* note 92, at 1197. The reaction also assumes that information regarding this type of misbehavior will be available. Indeed, the nondisclosure of information regarding conflicts may result in strict liability for the actions without any analysis of the fairness of the transaction. *See* Palmiter, *supra* note 91, at 1369-70.

111. An analysis focusing on the investor as the party interested in corporate governance is probably still too narrow. Employees, customers, and others dependent on the corporation are vitally interested from their own perspectives about the operations of the business. The voices of these individuals, however, typically have not been the direct focus of the corporate governance system. Instead, these interests have been protected through contract and through the web of regulation and liability systems that are directed toward the specific problems of these groups. Consumers are protected by federal and state consumer and safety regulation and through the product liability system. Employees are protected by labor laws and union contracts. Of course, this scheme has its detractors, but the goal here is to describe the system and its operation in bankruptcy rather than to analyze fully the effect of the system on these disparate groups. As to the effect of these other interests in bankruptcy, see *infra* text accompanying notes 279-86.

112. The focus here is on long-term financing arrangements provided by corporate bonds. Shorter term trade creditors and commercial paper holders are less prone to the effects of stockholder manipulations because the capital obtained through these means must be continually replaced.

113. *See* McDaniel, *supra* note 78, at 220-24.

114. *Id.* at 225-30. Commentators have identified three areas in which the conflict manifests: dividend payments that decrease the amount of assets available to satisfy creditor claims; claim dilution by issuing new debt at an equal or higher priority; and asset substitution from lower to higher risk investments. Each of these actions results in increasing the risk of debt (and correspondingly decreasing the prices of the bonds) to the shareholder's benefit. *Id.* at 226.

fully take account of the possibility of such behavior in setting the interest rate, shareholders may effect wealth transfers by increasing risk.[115]

While the corporation is solvent, the regulation of the creditor-shareholder relationship may be characterized as protective rather than managerial. Shareholders, as the residual claimants of the business, are primarily concerned with management's failure to maximize the asset values of the corporation. Creditors' concerns with managerial performance are limited to constraining behavior that increases the risk of the business enterprise. Thus, while shareholders retain broad rights to replace management through the mechanisms described above, creditors' concerns are addressed primarily by contractual provisions limiting specific types of behavior,[116] deemed at the contracting stage to increase enterprise risk beyond that for which the creditors have been compensated.[117]

Creditors may have an ally in management. Because managers are so heavily invested in the enterprise, they may be resistant to shareholder demands for increased risk.[118] Managers may be most secure in a corporation capitalized largely with equity because of the lack of fixed obligations, the greater likelihood of shareholder dispersion, and the increased total capital required to wage a takeover battle. Thus the effectiveness of shareholder controls may inversely impact the need for creditor protection.

B. The Slide Toward Insolvency

As the corporation approaches insolvency, shareholder-creditor conflicts become more pronounced. Shareholders put less and less capital at risk in each new business decision as the value of the corporation declines. Thus, shareholders' appetite for risk in the use of assets can be expected to increase.

In response to this increased conflict, the regulatory aspects of the credit relationship begin to change as the corporation encounters financial dif

115. *See* McDaniel, *supra* note 78 at 238-45.

116. In loan transactions the author has participated in, covenants include limitations on asset sales, new debt and liens, and the maintenance of certain levels of financial performance indicators such as net worth, debt coverage ratios, and working capital. The sanction for breach is acceleration — a withdrawal of capital from the organization. Thus, the effectiveness of the bond contract as a control over management discretion lies in the ability of the corporation to replace the capital through the market.

117. Bondholders, unlike shareholders, hold fixed priority claims against the income stream generated by the assets. When a corporation is truly solvent, bondholders are by definition assured full payment of their claims assuming nothing changes. Obviously, things do change over the life of a bondholder's relationship with the firm and, therefore, bondholders must be compensated for the risk that such changes ultimately may result in insolvency and corresponding losses to the bondholders. The amount of compensation required by bondholders is limited by the amount of risk assumed. Thus, as the covenants become stricter, the rate of compensation should decrease.

118. *See* Coffee, *supra* note 81, at 17-19.

ficulties. As the cash flow[119] and asset values[120] of the business weaken, creditors begin to take a more activist approach to governance issues. No longer will creditors be content to sit on the sidelines satisfied with their protections against specific actions. Thus, creditors begin to replace shareholders as the focal point in the governance system.

The governance system remains primarily contractual during this stage. Once business difficulties have reached a contractually determined level, the corporation will find itself in default of covenants that previously protected the creditors. These defaults provide creditors the right to withdraw capital from the enterprise.

The right to withdraw capital provides creditors with leverage needed to make the transition from a protective to a participatory relationship. The managers, hoping to avoid such withdrawal, may seek a waiver of the right, giving the creditors an opportunity to seek a more extensive role in corporate decisionmaking. For example, creditors may insist on asset sales to repay debt, additional capital infusions from sources outside of the corporation, restrictions on new debt, or replacement of key management personnel. If the financial crisis passes through a successfully completed workout, creditors may resume their protective relationship under revised contract terms.

As the corporation nears insolvency, legal restraints become effective to complement the market and contractual forces governing the relationship. Dividend restriction[121] and fraudulent conveyance[122] laws become applicable to remedy diversions of capital from the corporation. Preference laws[123] remedy the imbalance in debt payments made during the final days before bankruptcy. Finally, management's fiduciary duties of care and loyalty are extended to creditors along with shareholders.[124] These legal restraints

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119. Cash flow must be distinguished from the accounting concept of earnings. "[L]everaged companies [and their lenders] think of cash flow rather than earnings." Carol J. Loomis, *The Biggest Looniest Deal Ever*, FORTUNE, June 18, 1990, at 50. Cash flow is the actual cash generated by the business operations after taking into account payments to suppliers, laborers, landlords, and other input owners. It is this cash, less amounts necessary for capital expenditures, that is available for debt service.

120. Creditors are also concerned about asset values because these values provide a base level of protection in a worst case scenario. Upon liquidation of the corporation, creditors will be forced to seek payment of their claims from the assets themselves rather than cash flow.

121. *See, e.g.*, REV. MODEL BUS. CORP. ACT § 6.40 (1991); DEL. GEN. CORP. LAW § 170 (1991). Dividend restriction statutes are intended to insure that some level of capital remains available for the satisfaction of creditor claims by restricting the ability of shareholders to withdraw capital when the corporation is at or near insolvency. Commentators are somewhat skeptical about the effectiveness of these statutes, however. *See* CLARK, *supra* note 90, at 610-24.

122. *See, e.g.*, 11 U.S.C. § 548 (1988); UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 639 (1985); UNIF. FRAUDULENT CONVEYANCES ACT, 7A U.L.A. 427 (1985). Fraudulent conveyance laws address both transfers intended to hinder, delay, or defraud creditors and transfers for less than reasonably equivalent value (such as dividends) made when the corporation is insolvent or is rendered insolvent by the transfer.

123. *See* 11 U.S.C. § 547 (1988). Preference laws require the return of certain payments made to creditors immediately prior to bankruptcy to provide some assurance that similarly situated creditors are treated equally.

124. *See* Pepper v. Litton, 308 U.S. 295, 310-11 (1939). *See also* William Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 734 n.247; Stephen H. Case, *Fiduciary Duties of Corporate Directors and Officers, Resolution of*

operate in the same manner as fiduciary duties to shareholders operate outside of insolvency. They fill in the gaps of the contract-market controls over the relationship.

C. *Insolvency and Crisis: A Possible Governance Structure.*

At the bottom of the slide awaits crisis. Once a corporation has actually become insolvent, it is clear that the ownership structure must change. The most obvious method of change is to liquidate the business assets and to pay the proceeds to the owners in exchange for their ownership interests. Avoiding liquidation requires some type of reorganization under either bankruptcy or non-bankruptcy law. The reorganization process allows for creative solutions to this problem by providing a means by which the parties can renegotiate most of the contracts constituting the corporation. At the same time, the process raises significantly more governance problems than a simple liquidation because the preservation of the business usually necessitates a continuation of operations.

The corporate governance structure as it exists in solvent and failing corporations suggests an approach to governance of insolvent corporations. This approach places the creditors in the role of the group entitled to hold the residual authority over business decisions. The rationale for placing equity holders in a position of primacy in the governance framework of solvent corporations is that as the residual claimants, shareholders have a direct financial interest in marginal business decisions and are therefore in the best position to monitor management to ensure that it maximizes the value of the corporation's assets. Once a corporation is insolvent, creditors occupy this position and therefore should be cast in this monitoring role.[125]

From this premise one could envision an idealized reorganization process. After finding the locus of decisionmaking authority by identifying the group holding the residual claims, delegation and regulation principles could be applied in a manner similar to that existing outside of bankruptcy. The residual decisionmaking body could be trusted to make asset deployment decisions within the confines of the preexisting contractual limitations held by senior creditors since these residual claimants would have the appropriate incentives to maximize the corporation's asset value.[126]

Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases, WILLIAMSBURG CONFERENCE ON BANKRUPTCY 391 (ALI-ABA Invitational Conference 1988). *But see* McDaniel, *supra* note 78, at 267-68 (managers should act as fiduciaries of creditors as well as shareholders without regard to the solvency of the corporation).

125. "Once it becomes clear that there will not be enough to pay the creditors in full, continuing the decisionmaking authority in the hands of the shareholders and their agents effectively separates the decisionmaker from the group that stands to gain or lose as a consequence of the decision." JACKSON, *supra* note 35, at 167.

126. Unsecured creditors (assuming that they truly hold the residual claims) could exercise control over the composition of management through voting and vote aggregation procedures. Creditors who are senior in priority to the unsecured claimants could rely on protective devices imposed through bankruptcy procedures. Because equity claimants are no longer economically interested in the business by virtue of their previous ownership interests, they would be forced to bargain with the corporation on the basis of any values they could bring to the business in the future. *See supra* note 43 and accompanying text.

This analysis is deceptive in its simplicity. Although allowing the residual claimants to exercise control over the process should result in rational decisionmaking, the method can only work if one can readily identify this group. Such identification is no easy matter. The question calls for complex determinations of both asset values and the amount of liabilities that are the core problems of the reorganization process itself. If one could readily assess amounts of assets and liabilities, the entire bankruptcy process would be extremely simple. Suffice it to say that the process is not easy.[127]

One cannot simply ignore this difficulty and assume that a particular group of owners is well suited for the residual decisionmaking role. Because insolvency so often results in a crisis atmosphere in relations among the owners, economic incentives may clash as never before. Shareholders of the insolvent corporation will have an incentive to delay any final determination of asset values while increasing enterprise risk in the hopes of receiving some continuing interest in the corporation.[128] Creditors with a priority that ensures full payment of claims may nonetheless seek to withdraw from the failing entity.[129] The group holding the correct set of incentives will fall somewhere in-between. This group will realize any going concern value preserved by a reorganization and will fully bear the costs of reorganization and the risk of loss if the reorganization fails.[130]

Given the difficulties of the valuation process, the idealized reorganization will probably never be a reality. A rigid system of governance based upon illusive valuation models is simply unworkable. Pragmatic needs of speed and efficiency, as well as the inability to determine accurately the group holding residual claims, dictate a more fluid structure. Still, the nonbankruptcy governance principles set forth in this Section provide important

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127. In fact, valuation is such a difficult problem that the Code exhorts the parties to come up with negotiated solutions to the issues rather than force a full-blown judicial valuation. *See supra* text accompanying notes 28-43.

128. Baird provides the following example:

> Posit a firm with two owners. One is Creditor, who is owed $10 in a month's time, and another is Shareholder, who owns 100 percent of the firm's common stock. Both are risk neutral. Firm's sole asset is a lottery ticket that gives the owner a one in ten chance at a $100 prize. The drawing will take place in twenty-nine days. As the senior investor, Creditor, other things being equal, will favor converting the lottery ticket to $10 cash before the drawing. If Creditor is owed $10, keeping the ticket instead of selling it exposes Creditor to a 90 percent chance that he will not recover his investment. Yet in the cases in which Creditor does recoup his investment, his recovery is limited by the amount of his claim. A certain $10 is better than 10 percent chance of $10. Shareholder takes exactly the opposite view. Once the ticket is converted into cash, he is certain to receive nothing, while as long as the firm owns the ticket, he has a 10 percent chance of receiving $90. The firm as a whole is worth the same whether it has the lottery ticket or the proceeds from selling it, but in the first case the value of the Creditor's interest is $1.00, and in the other case the value of Creditor's interest is $10. If Creditor had the power to force Firm to convert the ticket into cash, he would exercise it.

Baird, *supra* note 8, at 131-32.

129. This can be expected precisely because of the problem posed, *supra*, at note 128.

130. This question is no different from the general question of who should hold the residual authority over corporate decisionmaking outside of bankruptcy. *See supra* text accompanying notes 76-80.

guides to the resolution of particular conflicts in Chapter 11. Many decisions made by managers in Chapter 11 are quite similar to those facing managers generally. The governance process outside of Chapter 11 reflects a collective view of the best method of organizing and controlling the decisionmaking process in an efficient manner. Thus, observations regarding the incentives of various groups, the proper role of fiduciary duties in the process, and the desirability of some form of extra-judicial controls on managerial behavior can inform the analysis of governance in Chapter 11.

III. The Bankruptcy Governance System

Since the Securities and Exchange Commission's study of protective committees in the 1930's,[131] governance of firms in bankruptcy has been of concern to those studying and practicing bankruptcy law. The Chandler Act,[132] enacted in the late 1930's, provided a governance system that was intended to place an independent trustee at the helm of the bankrupt public corporation.[133] After substantial debate,[134] Congress, in enacting the Code, rejected the requirement of a mandatory trustee in favor of leaving the debtor in possession of its assets.[135] Because a corporation can only act through agents, the concept of a debtor in possession insures the debtor's prepetition management a central role in the reorganization process.[136]

The conclusion that management should be left in control of the corporation's business decisions only opens the debate. Managerial control requires regulation, but regulatory controls should be consistent with the purposes of the process in which they are found. The special needs of the Chapter 11 process severely limit the non-bankruptcy governance system by eliminating its contract and market aspects. Chapter 11 provides additional representational structures and judicial controls to counterbalance the resulting managerial autonomy. This Section first analyzes the need for such limitations and then describes Chapter 11's replacements for the contract and market controls.

A. Bankruptcy Limitations on the Corporate Governance Structure

The bankruptcy of the Johns-Manville Corporation provides an excellent example of the tension between the non-bankruptcy governance system and the special problems encountered in the reorganization process. The *Johns-*

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131. Securities and Exchange Commission, Report on the Study of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937-1940). *See* Michael A. Gerber, *The Election of Directors and Chapter 11 — The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 Brook. L. Rev. 295, 297-307 (1987), for a discussion of the SEC report.

132. 52 Stat. 840 (1938) (codified at 11 U.S.C. § 530, *repealed*).

133. *See* Gerber, *supra* note 131, at 300-03.

134. 11 U.S.C. § 1104(a) (1988) is a compromise between the House version of the bill that ultimately became the Bankruptcy Code and a Senate Amendment. A discussion of the Congressional debate over the question can be found in Robert J. Berden & Bruce G. Arnold, *Displacing the Debtor in Possession: The Requisites For and Advantages of the Appointment of a Trustee in Chapter 11 Proceedings*, 67 Marq. L. Rev. 457, 460-69 (1984).

135. *See* 11 U.S.C. § 1104(a) (1988); Berden & Arnold, *supra* note 134, at 469.

136. Nimmer & Feinberg, *supra* note 2, at 21.

Manville cases[137] involved a situation in which management and various creditor groups, including the representatives of asbestos claimants, engaged in three years of arduous negotiations over the terms of a reorganization plan. Upon the distribution of an agreement that would have diluted shareholders' equity by ninety percent, a member of the equity committee filed suit in a Delaware court seeking an order requiring a shareholder meeting. Manville, along with several other creditor constituencies, sought an injunction prohibiting the meeting.

In granting the injunction, the bankruptcy court found that the express purpose of any such meeting would be to replace the current Manville board with directors who would be more sympathetic to the shareholders' interests.[138] In fact, the Equity Committee's conceded objective was to provide the shareholders with negotiating leverage by attempting to scuttle the agreement between Manville and its creditors.[139] The bankruptcy court also found that the shareholders' efforts would jeopardize the debtor's ability ever to confirm a plan of reorganization.[140]

The Second Circuit reversed the bankruptcy court's injunction and held that the shareholders' right to hold a meeting subsists during a Chapter 11 case.[141] The court went further and stated that the Equity Committee's desire to obtain leverage over other participants in the reorganization did not constitute "clear abuse" sufficient to justify enjoining the meeting.[142] Rather, the Second Circuit required a showing that the shareholders were bargaining in bad faith by showing a "willingness to risk rehabilitation altogether to win a larger share for equity."[143] On remand, the bankruptcy court supplemented its findings to include the required showing and again entered the injunction.[144]

The question of whether shareholders' meetings should be allowed in Chapter 11 aptly illustrates the difficulties encountered in the application of general governance systems in Chapter 11. The ability to displace management is an essential element of the non-bankruptcy governance system but is normally granted to the residual claimants of the corporation's assets. Granting the shareholders this right in Chapter 11 seems to imply that they continue to occupy this position.

The Second Circuit recognized this problem but found that the solvency of the corporation was not an issue: "We note that if Manville were determined to be insolvent, so that the shareholders lacked equity in the corpora-

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137. *In re* Johns-Manville Corp., 52 B.R. 879 (Bankr. S.D.N.Y. 1985), *aff'd*, 60 B.R. 842 (S.D.N.Y. 1986), *rev'd*, 801 F.2d 60 (2d Cir. 1986), *on remand*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986).

138. *Id.* at 885.

139. *Id.* at 887.

140. *Id.* at 889.

141. 801 F.2d 60.

142. *Id.* at 64.

143. *Id.* at 65.

144. Several other cases have addressed the shareholder meeting problem. For an exhaustive analysis, see Gerber, *supra* note 131, at 321-41.

tion, denial of the right to call a meeting would likely be proper, because the stockholders would no longer be real parties in interest."[145]

Thus, the Second Circuit recognized that traditional governance principles would focus on the solvency of the company in an attempt to find the residual claimants.

Johns-Manville also illustrates the pragmatic limitations on the governance system. *Johns-Manville* was a case about leverage and strategic behavior — not about higher principles of economic efficiency and monitoring.[146] The shareholder suit was intended to provide the shareholders additional leverage with which to negotiate a larger share of the reorganized corporation.[147] The Second Circuit was willing to condone the use of such leverage but only up to the point at which it threatened to "torpedo the reorganization."[148] Thus, the need to reorganize may be found to justify the limitation of corporate governance principles. Indeed the bankruptcy court in *Johns-Manville* embraced that very justification.[149]

Pragmatic concerns also impair the governance system as it applies to the creditors. Chapter 11 is designed to reduce the collective action problems that diverse ownership interests create. Baird and Jackson have developed a theory of bankruptcy that focuses on the collective action problems facing the owners of a troubled company:

> When the ownership of a firm is diverse and the individual owners have different packages of rights ... all have an incentive to take actions that will increase their own share of the assets of an ailing firm, even if in doing so they deploy assets in a way that a sole owner would not. Bankruptcy law, at bottom, is designed to require these investors to act collectively rather than to take individual actions that are not in the interests of the investors as a group.[150]

The automatic stay is the Code's principal means of fulfilling this policy. In the absence of the stay, each creditor would have the incentive to take the steps required to withdraw its capital from the enterprise. Because insolvency presumes that assets are insufficient to satisfy each creditor's claim in full, each creditor would have an incentive to be the first in line. The resulting

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145. 801 F.2d at 65 n.6. The court's use of the term "party in interest" is somewhat unfortunate because 11 U.S.C. § 1109(b) (1988) clearly includes equity interest holders within the term "party in interest." *See infra* note 152.

146. The district court clearly recognized this fact:

> By its own admission, the Equity Committee brought the [action seeking a shareholder's meeting] in order to derail the proposed plan. Either the appellants seek to destroy any prospect for a successful reorganization, or they wish to use the threat of a new board as a lever vis-a-vis other interested constituencies and vis-a-vis the current Manville board.

Johns-Manville, 60 B.R. at 852.

147. 801 F.2d at 64.

148. *Id.* at 64-66.

149. 66 B.R. at 542.

150. *Diverse Ownership Interests*, *supra* note 15, at 106.

race under disparate debt collection systems would result in a breakup of assets — a course of action that may not maximize overall asset values.[151]

Thus, while necessary to obviate collective action problems, the automatic stay guts the non-bankruptcy corporate governance structure. Once a bankruptcy case is filed, contractual controls no longer effectively provide creditors or shareholders the leverage needed to control the corporate managers. Some replacements are necessary.

B. Bankruptcy Substitutes for Contract and Market Controls

Chapter 11 replaces the contractual and market aspects of the general corporate governance framework with a system of owner representation and with increased judicial oversight of management's actions. Judicial oversight is both general and specific. Fiduciary duties and provisions for management ouster make up general controls on managerial failure. These general governance controls work in a manner similar to legal constraints on managerial misbehavior outside of bankruptcy. Judicial oversight also applies to specific decisions. The decision to seek financing during the case, to assume or reject executory contracts, and to sell assets are all subject to judicial oversight using standards developed by the courts. The following discussion first looks at the Code's owner representation provisions and then at these general and specific controls on managerial actions.

1. Representation

The controls on management behavior in Chapter 11 rely to a great extent on the ability of the owners to place control issues before the bankruptcy court. While the Code provides any "party in interest"[152] the ability to raise and be heard on any issue in the case,[153] some system of representation is necessary for two reasons. First, because a business usually has many owners, negotiation and monitoring by all of the interested parties would prove fruitless quickly. There is simply not enough room at the bargaining table or in the courtroom (physically as well as figuratively) for everyone to participate fully in the process. Second, not all owners will even desire active involvement in the case. The costs of participation, both in terms of managerial and legal time, may therefore effectively silence many owners in the negotiation process. Owners with small claims may lack sufficient incentives to invest the time and money that a true contribution may require.[154]

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151. BAIRD & JACKSON, *supra* note 60, at 40-41.

152. The Code does not define the term "party in interest" other than to state that the term includes "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or an indenture trustee." 11 U.S.C. § 1109(b) (1988). Besides these interests, the term "party in interest" should include entities with an actual stake in the outcome of the case. *Compare In re* Amatex, Inc. 755 F.2d 1034, 1042-43 (3d Cir. 1985) (future claimants, though not readily identifiable, have an interest in the case sufficient to warrant the appointment of a legal representative with the status of a party in interest) *with In re* Ionosphere Clubs, Inc. 101 B.R. 844, 849 (Bankr. S.D.N.Y. 1989) (rejecting Consumers Union's claim that its status as protector of the consumer warranted party in interest status).

153. 11 U.S.C. 1109(b) (1988).

154. This problem is similar to the rational indifference hypothesis posed, *supra*, at text accompanying notes 81-83. Bankruptcy actually may exacerbate the problem because creditors' claims normally will be reduced through the process. If the assets of the business will yield a

The Code addresses this difficulty through the provisions requiring the appointment of a creditors' committee — the central body representing the unsecured creditors in a Chapter 11 case. Section 1102 of the Code requires the United States Trustee to appoint a committee of creditors holding unsecured claims as soon as is practicable after the commencement of the case.[155] The committee is charged with the responsibility of participating in plan formulation and of advising creditors on any plan filed in the case.[156] The committee also has monitoring and investigative responsibilities[157] to counterbalance the informational and other advantages of management.[158] As the chief representative of what is often the largest group of interested parties, the committee may wield broad influence over the course of the proceedings.[159]

Because the committee is the primary negotiating body for such a large group of claimants, the representative character of the committee members is essential. In the modern world of corporate finance, the term "unsecured creditors" can be misleading in its apparent simplicity. The term includes creditors with a wide range of priorities and potentially conflicting incentives. Holders of senior unsecured debt can have quite a different perspective on the reorganization than do creditors holding junior subordinated debt.[160] Also, employees holding claims for unpaid wages and trade creditors may be willing to forgo repayment of much of their debt if necessary to assure the reorganization of the company.[161]

The Code addresses this problem by providing the court with authority to appoint additional committees if necessary to assure adequate representation.[162] Balanced against the need for adequate representation, however, is the need to contain costs and keep the number of negotiating parties to a

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payment to creditors of ten cents on the dollar, creditors will have even less incentive to invest the time and to expend the funds required for a meaningful contribution.

155. 11 U.S.C. § 1102(a) (1988).

156. 11 U.S.C. § 1103(c)(3) (1988).

157. 11 U.S.C. §§ 1103(c)(1), (2) & (4).

158. *See infra* text accompanying notes 249-51.

159. In approving a creditors' committee's request for reimbursement, the Ninth Circuit, in *In re* George Worthington Co., 921 F.2d 626 (9th Cir. 1990), stated:

> Under the scheme adopted by the Bankruptcy Reform Act of 1978 [the code], i.e., with the bankruptcy judge removed from active participation in the case and the preference for leaving the debtor in possession, a § 1102 committee has a more important role in terms of monitoring the debtor's business life and developing the terms of the plan of reorganization.

Id. at 633 (quoting *In re* GHR Energy Corp., 35 B.R. 539, 543 (Bankr. D. Mass. 1983)).

But see Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 183 (1987) (studies of bankruptcy cases indicate that creditors' committees were "active" in only 16%-38% of the Chapter 11 cases studied).

160. Secured creditors find their place at the bargaining table through the unique nature of their claims rather than through a committee structure. The Code's provisions governing the plan of reorganization require a classification of claims and generally require that secured creditors each be placed in a separate class for purposes of treatment under the plan and voting. *See* 11 U.S.C. § 1122(b) (1988). Separate classification requires that secured creditors be included individually in the negotiations leading to a consensual plan of reorganization. Thus, the traditional secured lender will not require a separate representational structure.

161. *See In re* Altair Airlines, 727 F.2d. 88, 90 (3d Cir. 1984).

162. 11 U.S.C. § 1102(a)(2) (1988).

manageable level. Courts have recognized this difficulty and countenance a high level of conflict in the committee structure.[163]

The Code also provides for the appointment of equity security holders' committees if necessary to assure adequate representation of shareholder interests.[164] Courts use three guidelines to analyze the question of whether an equity committee is appropriate. First, courts are more likely to appoint a committee if the number of shareholders is large. Second, an equity committee is more likely to be appointed if the case is particularly complex. Finally, the court must consider whether the benefits of a committee significantly exceed the costs.[165] To the extent that management does not align itself with the interests of shareholders, a committee representing their interests in the plan process may be appropriate.[166]

2. General Controls

a. Fiduciary Duties.

One of the most fundamental principles of bankruptcy governance requires that the management of the bankrupt corporation act as a fiduciary of the corporation.[167] This relatively simple statement is the center around which bankruptcy governance issues revolve, but like many exhortations in the law, the notion does little standing alone to resolve actual conflicts among economically interested parties. As a guiding principle, the rule says much. As a real means of sorting out the conflicts among diverse owners, however, the rule says little.

The bankruptcy fiduciary duty points management in the direction of acting in the interests of both creditors and shareholders.[168] Management is called upon to operate the business in accordance with this principle — maximizing the value of the assets of the reorganizing company while attempting to sort out the conflicts among pre-bankruptcy owners in some reasoned way.[169] This role necessarily places management in a conflicting position in

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163. *See, e.g., In re* Baldwin United Corp., 45 B.R. 375, 376 (Bankr. S.D. Ohio 1983) ("Conflicts among creditors are inevitable in all bankruptcy cases."); *In re* Texaco Inc., 79 B.R. 560, 567 (Bankr. S.D.N.Y. 1987) ("Dissident factions of the same class of creditors are not automatically entitled to separate committees."); *In re* Sharon Steel Corp., 100 B.R. 767, 776-80 (Bankr. W.D. Pa. 1989) (exhaustive review of cases in which inherent conflicts did not rise to the level sufficient to justify appointment of a separate committee).

164. 11 U.S.C. § 1102 (1988).

165. *Johns-Manville*, 68 B.R. at 159-60; *In re* Mansfield Ferrous Castings, Inc., 96 B.R. 779, 781 (Bankr. N.D. Ohio 1988).

166. *See* S. REP. NO. 989, 95th Cong., 2d Sess. 10 (1978) (purpose of allowing court to appoint an equity security holders' committee is "to counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of small and scattered public investors.").

167. "[T]he willingness of courts to leave debtors in possession is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary duties of a trustee." Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343 (1985), *on remand*, 776 F.2d 1049 (7th Cir. 1986). *See also* Wolf v. Weinstein, 372 U.S. 633, 651, *reh'g denied*; 373 U.S. 928 (1963); *In re* Johns-Manville Corp., 60 B.R. 612 (Bankr. S.D.N.Y. 1986); Nimmer & Feinberg, *supra* note 2, at 25.

168. Nimmer & Feinberg, *supra* note 2, at 2-4.

169. *Id.* at 25-29.

making actual decisions.[170] The interests of the various creditors and shareholders almost always will be in conflict in the Chapter 11 process because the process involves a zero sum game in which there will be winners and losers. Because some party must operate the business and control the process, management seems as well suited as any group to make the tough decisions called for by the collapse. Thus as a general principle, the fiduciary duty notion seems to direct management to do the best it can in a difficult situation.

Hortatory principles are important in the law because most people take them to heart and try to live by them. The fiduciary duties of management in Chapter 11 are no exception. In most cases, one can cast aside cynicism and expect managers to act on the basis of what they perceive to be the common good. Still, the law must provide controls for those other cases and probably should provide more specific limitations on managers than a generalized mandate to do good as they perceive it.

The actual rules implementing the fiduciary duty principle in bankruptcy, like those existing outside of bankruptcy, cannot be expected to align management completely with the interests of all of its constituencies. Bankruptcy courts recognize the difficulties of judging managerial discretion under the fiduciary standard and have developed rules that echo the dual standards of loyalty and care existing in the non-bankruptcy governance regime.

In cases of clear conflict, such as self-dealing, and in cases of direct violation of statutory duties,[171] the courts hold management to the strictest of standards.[172] In one of the most enduring statements of management's duty of loyalty in bankruptcy, Justice Douglas wrote:

> A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.[173]

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170. *Id.* at 2; Case, *supra* note 124, at 398-405.

171. *See* 11 U.S.C. §§ 1106, 1107 (1988) (The duties of the debtor in possession include accounting for all property received, furnishing information to any party in interest, determining taxes from operating the business, and filing a plan of reorganization). The duties of the debtor include filing a list of the creditors and a schedule of assets and liabilities. The debtor is also required to cooperate with the trustee, if one has been appointed. *See* 11 U.S.C. § 521(b)(3) (1988).

172.

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the disintegrating erosion of particular exceptions.

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (citation omitted).

173. *Pepper*, 308 U.S. at 306 (citations omitted).

The standards existing inside of bankruptcy do not differ much from the standards outside of the process.[174] Thus, bankruptcy courts have held that managers have breached their fiduciary duty where they trade in claims against the corporation,[175] use estate assets to pay creditors with whom they expect to deal in future enterprises,[176] use assets to pay claims owed by the managers,[177] and allow relatives to use estate assets without compensating the estate.[178] Each of these actions involves a direct conflict resulting in misbehavior and, not surprisingly, the courts are quick to condemn such actions.

In contrast to the court's strict review of transactions presenting an actual conflict of interest is their deference to managerial discretion in situations uncomplicated by such conflicts. In analyzing management actions that fall under the Code's grant of authority to operate the business,[179] courts use language reminiscent of the business judgment rule. For example, in *In re Johns-Manville*,[180] the creditors' committee objected to the debtor's use of estate funds to pay lobbyists representing it in connection with pending legislation. In overruling the objection the court stated:

> [T]he Code favors the continued operation of a business by a debtor and a presumption of reasonableness attaches to a debtor's management decisions.... Where the debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), courts will generally not entertain objections to the debtor's conduct.[181]

Thus, the business judgment standard exists in the analysis of fiduciary duties in bankruptcy.[182] The reasoning behind this deference is not different from that existing outside of bankruptcy. Management is better suited than the courts to make decisions requiring business judgments.[183]

b. Replacing Management

The Code's provisions allowing the court to replace the management of the corporation constitute a second general governance control. Like fiduciary duties, this aspect of the Chapter 11 governance structure effectively controls serious concerns over management's ability to run the corporation, but may be ineffective to check management misbehavior in situations other than those involving a direct conflict or other serious management problems.

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174. *See In re* Schipper, 112 B.R. 917, 919 (Bankr. N.D. Ill. 1990), *aff'd*, 933 F.2d. 513 (7th Cir. 1991).

175. *See Wolf*, 372 U.S. 633, 647.

176. *See In re* Weber, 99 B.R. 1001, 1013 (Bankr. D. Utah 1989).

177. *See In re* Plaza Family Partnership, 95 B.R. 166, 172 (Bankr. E.D. Cal. 1989).

178. *See In re* E. Paul Kovacs & Co., 16 B.R. 203, 205 (Bankr. D. Conn. 1981).

179. *See infra* text accompanying notes 224-34 for an analysis of the limits of the debtor in possession's operating authority.

180. 60 B.R. 612.

181. *Id.* at 615-16 (citations omitted).

182. *See* Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d. 1303, 1311 (5th Cir. 1985); *In re* Wheeling-Pittsburgh Steel Corp., 103 B.R. 672, 690 (Bankr. W.D. Pa. 1989).

183. "Disagreements over business policy are not amenable to judicial resolution." *In re* Curlew Valley Assocs., 14 B.R. 506, 513 (Bankr. D. Utah 1981).

The primary means of replacing management is by a motion requesting the appointment of a trustee under Section 1104 of the Code. Courts universally hold that the appointment of a trustee is an "extraordinary remedy."[184] The presumption remains that management should continue to operate the business, and that the displacement of management is a remedy to be granted only on clear and convincing evidence that the appointment is warranted.

Section 1104[185] provides two bases upon which the court may rest an order appointing a trustee. The first of these grounds, contained in Section 1104(a)(1), is "cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause."[186] This language dovetails into the general fiduciary duty of loyalty owed by management to the corporation's creditors and shareholders. Appointment for cause is intended to remedy obvious instances of management misbehavior rather than subtle conflicts or general control problems.

The second ground for the appointment of a trustee, contained in Section 1104(a)(2), requires that "such appointment is in the best interest of creditors, and equity security holders, and other interests of the estate."[187] This language provides the courts the flexibility to "eschew rigid absolutes and look to the practical realities and necessities."[188] Courts consider the following factors: "(i) the trustworthiness of the debtor; (ii) the debtor in possession's past and present performance and prospects for the debtor's rehabilitation; (iii) the confidence — or lack thereof — of the business community and of creditors in present management; and (iv) the benefits derived by the appointment of a trustee, balanced against the cost of the appointment."[189]

While the necessity of removing management in circumstances of fraud or dishonesty seems clear enough,[190] the removal of management for gross mismanagement or under a best interests test requires further analysis. These somewhat broader bases for appointment of a trustee appear to provide courts

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184. *See, e.g.*, *In re* Ionosphere Clubs, Inc., 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990); *In re* Cardinal Indus., Inc., 109 B.R. 755, 765 (Bankr. S.D. Ohio 1990); *In re* Microwave Prods. of Am., 102 B.R. 666, 670 (Bankr. W.D. Tenn. 1989); *In re* Sharon Steel Corp., 86 B.R. 455, 457 (Bankr. W.D. Pa. 1988), *aff'd*, 871 F.2d 1217 (3d Cir. 1989); *In re* Nautilus of New Mexico, Inc., 83 B.R. 784, 788 (Bankr. D.N.M. 1988); *In re* McCorhill Publishing, Inc., 73 B.R. 1013, 1016-17 (Bankr. S.D.N.Y. 1987); *In re* Parker Grande Dev., Inc., 64 Bankr. 557, 560 (Bankr. S.D. Ind. 1986); *In re* Colby Constr. Corp., 51 B.R. 113, 116 (Bankr. S.D.N.Y. 1985); *In re* Evans, 48 B.R. 46, 47 (Bankr. W.D. Tex. 1985); *In re* L.S. Good & Co., 8 B.R. 312, 314 (Bankr. N.D. W. Va. 1980); *In re* Hotel Assocs., Inc., 3 B.R. 343, 345 (Bankr. E.D. Pa. 1980).

185. 11 U.S.C. § 1104(a) (1988).

186. *Id.* § 1104(a)(1). This section of the Code specifically states that cause does not include "the number of holders of securities or the amount of assets or liabilities," thus reflecting the outcome of the debate over whether a trustee should be appointed in cases involving "public companies." *See supra* note 134.

187. 11 U.S.C. § 1104(a)(2).

188. *Ionosphere Clubs*, 113 B.R. at 168; *Hotel Assocs.*, 3 B.R. at 345.

189. *Ionosphere Clubs*, 113 B.R. at 168 (citations omitted).

190. Even in cases where management has engaged in actions which are dishonest, however, the bankruptcy court retains the discretion to deny a motion for the appointment of a trustee. *See* Committee of Dalkon Shield Claimants v. A.H. Robbins Co., 828 F.2d. 239 (4th Cir. 1987).

with an opportunity to address general managerial shirking and the failure of management to closely align itself with the interests of the residual claimants. Courts do not appear to be taking this opportunity, however.

The flexibility of Section 1104(a)(2) and the breadth of the term "mismanagement" are tempered by the restrictive attitudes of the courts in the application of the standards. Courts recognize that mismanagement has usually occurred to some extent in all bankruptcy cases and hold that the management should be given an opportunity to correct past mistakes.[191] "Gross mismanagement suggests some extreme ineptitude on the part of management to the detriment of the organization."[192] Furthermore, the fact that someone else may operate the business more effectively is not grounds for the appointment of a trustee.[193] Except in extreme cases, something more than managerial quality is at issue in these decisions.

What is usually at the heart of the cases ordering the appointment of a trustee is either some management conflict of interest[194] or a judicial realization that a lack of creditor confidence in the abilities of management has reached crisis proportions.[195] Like fraud or dishonesty, little needs to be said here of the cases involving direct conflict. They clearly and directly fit within the broad notions of the duty of loyalty under the fiduciary standards existing inside and outside of the Chapter 11 process.[196]

Of more interest in this analysis are the cases involving a loss of confidence in the management of the debtor. If handled under appropriate standards, these cases could provide an adequate substitute for the loss of contractual controls resulting from the pragmatic needs of the reorganization process. The only question[197] is whether the standards used by courts are adequate to the chore.

An examination of the cases in which courts have reviewed a request for appointment of a trustee based upon a lack of creditor confidence yields few general observations. It appears, however, that the lack of confidence in

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191. *See, e.g., Evans*, 48 B.R. at 47.

192. *In re* Mako, Inc. 102 B.R. 809, 812 (Bankr. E.D. Okla. 1991) (citing *In re* Brown, 31 B.R. 583 (D.D.C. 1983)).

193. *See Microwave Prods.*, 102 B.R. at 671.

194. *See In re* Sharon Steel Corp., 871 F.2d 1217 (3d Cir. 1989) (careless management practices including payments without consideration to chief executive officer); *Nautilus*, 83 B.R. 784 (co-owner president also manager and largest creditor); *McCorhill Publishing*, 73 B.R. 1013 (prepetition transfers to affiliates and failure to maintain complete records); *Colby Constr.*, 51 B.R. 113 (majority shareholder use of corporate assets and failure to maintain accurate records); *In re* Concord Coal, Corp., 11 B.R. 552 (Bankr. W.D. W. Va. 1981) (loyalty of the management called into question by many competing businesses and potential for inter-company dealings).

195. *See, e.g., Cardinal Indus.*, 109 B.R. 755 (creditors' crisis of confidence in management).

196. In fact, one basis of the court's recognition of the necessity of the appointment is that the conflicts impair the ability of the debtor to act as a fiduciary. Thus, some courts collapse the fiduciary duty analysis discussed earlier into the appointment analysis. *See, e.g., Microwave Prods.*, 102 B.R. at 671-72; *Sharon Steel*, 871 F.2d at 1227-28.

197. Of course, one might object that the judicial process is incapable of making such decisions. The response is simply to ask what other means might be better given the nature of the problem.

these cases typically accompanies a lack of progress in plan negotiations,[198] continuing losses during the case,[199] doubts in the ability of the debtor to reorganize,[200] failure to provide information to the participants,[201] or direct violation of statutory requirements.[202] Generally, unless the lack of confidence approaches critical proportions, courts are reluctant to grant the extraordinary remedy of appointing a trustee.[203]

There are good reasons for the courts to set high standards for displacing management and appointing a trustee. One of the main reasons is the high cost such an appointment will entail. Trustees and their lawyers must be paid.[204] Bankruptcy is an expensive proposition to begin with, and a trustee may add unnecessarily to those costs. Courts are extremely sensitive to cost issues[205] and will be understandably reluctant to add to the number at the trough. Also, there is no assurance that a trustee who has had no prior relationship to the business of the corporation will do any better job in running the business than current management. Finally, courts must be alert to the underlying motive driving the motion for appointment.[206] These problems indicate that some balance is required.

The courts' reluctance to appoint a trustee renders this governance control, like the fiduciary duty control, an inadequate substitute for the con-

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198. *See Ionosphere Clubs*, 113 B.R. at 169; *Cardinal Indus.*, 109 B.R. at 766. *See supra* text accompanying notes 28-43 for a discussion of the plan negotiation process.

199. *See, e.g.*, *Ionosphere Clubs*, 113 B.R. at 169; *Cardinal Indus.*, 109 B.R. at 762.

200. *See, e.g.*, *Hotel Assocs.*, 3 B.R. at 345; *L.S. Good*, 8 B.R. at 315.

201. *See, e.g.*, *Cardinal Indus.*, 109 B.R. at 762; *Colby Constr.*, 51 B.R. at 117.

202. *See, e.g.*, *Evans*, 48 B.R. at 48.

203. In addition to the appointment of a trustee, two other means of replacing management are worthy of note. Courts in a few cases have approved the appointment of new management outside of the restrictions provided in 11 U.S.C. § 1104. These cases generally involve special circumstances, such as consent of management or a complete lack of management. *See, e.g.*, *In re* Gaslight Club, Inc., 782 F.2d 767 (7th Cir. 1986) (management consent to the appointment of a "responsible officer"); *In re* United Press Int'l, Inc., 60 B.R. 265 (Bankr. D.D.C. 1986) (consent order abolishing the debtor's board of directors upheld); *In re* Boileau, 736 F.2d 503 (9th Cir. 1984) (consent to appointment of examiner with authority to operate the business); *In re* John Peterson Motors, Inc., 47 B.R. 551 (Bankr. D. Minn. 1985) (same); *In re* FSC Corp., 38 B.R. 346 (Bankr. W.D. Pa. 1983) (court appointed "responsible officer" where corporation had no management or board of directors when it filed petition). *Cf. In re* Lifeguard Indus., Inc., 37 B.R. 3 (Bankr. S.D. Ohio 1983) (court refused to approve new management slate proposed by majority shareholder).

The second method of replacing management may be for shareholders to call a meeting under state corporate statutes. *See supra* text accompanying notes 137-49. Because most corporations in Chapter 11 can be presumed to be insolvent, however, a shareholders' meeting likely grants control over management to the group that is least likely to have the appropriate incentives to insure that management makes decisions that will maximize the value of the business. *See supra* text accompanying notes 76-80.

204. 11 U.S.C. § 330 (1988) (The court may award reasonable compensation for services by the trustee, examiner, or professional person.); *Id.* § 327 (The trustee, with court approval, may hire an attorney or any other professional person to assist the trustee in his or her duties.).

205. *See, e.g.*, *Parker Grande Dev.*, 64 B.R. at 561; *Microwave Prods.*, 102 B.R. at 676; *Cardinal Indus.*, 109 B.R. at 766.

206. Courts should be vigilant against motions for the appointment of a trustee motivated by tactical considerations unrelated to the quality of existing management. *See In re* Stein and Day, Inc., 87 B.R. 290, 295 (Bankr. S.D.N.Y. 1988).

tractual aspects of the non-bankruptcy governance system. The high standards used by courts, while understandable, result in a rigidity that renders the control ineffective to counteract any split between management and its constituencies. This observation should not be taken as a call for increased use of trustees, however. The remedy is indeed drastic — so drastic that courts should continue to see it not as a substitute for the contract and market aspects of corporate governance, but rather as a continuation of the purely legal controls on extreme management misbehavior.

Short of the extraordinary remedy of appointing a trustee, the Code provides the court the authority to appoint an examiner.[207] Facially, the Code requires the court to order the appointment upon the request of a party in interest[208] in cases in which fixed, unliquidated, unsecured claims exceed $5 million.[209] A few courts have, however, refused to appoint an examiner even in these larger cases,[210] and commentators have called for the abandonment of mandatory appointments.[211] In smaller cases, the court may order the appointment only on a showing that the appointment is in the best interests of the creditors.[212]

The statutory language suggests that the functions of an examiner are investigatory. Section 1104(b) provides that the examiner may be appointed "to conduct such an investigation of the debtor as is appropriate, including an investigation into any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the

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207. 11 U.S.C. § 1104(b).

208. Courts also have the authority to appoint an examiner *sua sponte*. *See, e.g., In re* Public Serv. Co. of New Hampshire, 99 B.R. 177, 182 (Bankr. D.N.H. 1989); *In re* UNR Indus., Inc., 72 B.R. 789, 793-95 (Bankr. N.D. Ill. 1987); *In re* Landscaping Servs., Inc., 39 B.R. 588, 590 (Bankr. E.D.N.C. 1984).

209. 11 U.S.C. § 1104(b)(2).

210. *See, e.g., In re* Revco D.S., Inc., 93 B.R. 119 (Bankr. N.D. Ohio 1988), *appeal dismissed*, 99 B.R. 778 (N.D. Ohio 1989), *rev'd*, 898 F.2d 498 (6th Cir. 1990) (appointment premature since two committees actively investigating leveraged buy-out); *In re* GHR Cos., 11 Collier Bankr. Cas. 2d (MB) 604, 615-16 (Bankr. D. Mass. 1984) (section 1104(b)(2) only applies to public companies); *In re* Shelter Resources Corp., 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983) ("[T]o slavishly and blindly follow the so-called mandatory dictates of Section 1104(b)(2) is needless, costly and non-productive and would impose a grave injustice on all parties herein."). These cases may be somewhat aberrational because since they were decided, the Supreme Court has made clear that bankruptcy cases should be decided strictly on the basis of the clear language of the Code. *See* United States v. Ron Pair Enters., Inc., 489 U.S. 235 (1989); Toibb v. Radloff, 111 S. Ct. 2197 (1991).

211. *See* CONCLUSIONS OF THE PANELS, THE WILLIAMSBURG CONFERENCE ON BANKRUPTCY — CRITIQUE OF THE FIRST DECADE UNDER THE BANKRUPTCY CODE AND AGENDA FOR REFORM, Transcript 3 (ALI-ABA 1989) (concept of mandatory appointment of examiner should be eliminated); Lawrence K. Snider, *The Examiner in the Reorganization Process: A Need to Modify*, 45 BUS. LAW. 35, 55 (1989) (same).

212. 11 U.S.C. § 1104(b)(1). This best interest standard should not be confused with the similarly worded standard for the appointment of a trustee under 11 U.S.C. § 1104(a)(2). Appointment of an examiner does not displace management as does appointment of a trustee. Examiners' primary functions are investigatory, not managerial. *See infra* text accompanying notes 213-14. Thus, the standard for the appointment of an examiner should not be as high as that required for the appointment of a trustee. *See* Snider, *supra* note 211, at 37; 5 COLLIER ON BANKRUPTCY § 1104.03[b] (15th ed. 1991).

debtor."[213] Section 1106, which details the duties of the examiner, continues this investigatory theme.[214]

Notwithstanding the statutory emphasis on managerial misconduct, the scope of the examiner's inquiry may be broad.[215] In *In re UNR Industries*,[216] for example, the court ordered the examiner to "determine whether negotiations toward a consensual plan of reorganization [were] at an impasse."[217] *UNR* involved numerous complex issues arising out of the corporation's potential liability to persons injured by asbestos.[218] The court was concerned particularly about the possibility of a cramdown because of the difficulty of these issues, the resolution of which was expected to consume at least five years.[219] Apparently, the examiner was successful because the UNR plan was confirmed on June 1, 1989.[220]

Several courts have broadened the examiner's role further, charging the examiner with the mediation of disputes over the plan of reorganization,[221] bringing suits on behalf of the estate,[222] and, in a few cases, operating the debtor's business.[223] In these cases, the courts have recognized that an examiner may fulfill the need for an impartial voice in the process while avoiding the disruption created by the appointment of a trustee.

3. Judicial Control over Specific Decisions

In addition to the general controls on managerial actions, the Code requires managers contemplating significant corporate actions to obtain judicial approval. This requirement constitutes an important replacement of the contract and market controls operating outside of the Chapter 11 process. The following discussion describes the limits of managerial authority and the standards for approval of significant financing, executory contract, and asset sale decisions.

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213. 11 U.S.C. § 1104(b).

214. 11 U.S.C. § 1106(a)(3) (1988) requires the examiner to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or the formulation of a plan." Section 1106(a)(4) requires the examiner to file a statement of any investigation conducted and to transmit a copy to the creditors' committees.

215. For a general discussion of one examiner's experiences in a large reorganization, see Stanley A. Kaplan, *The Role of the Examiner: Some Observations*, 4 BANKR. DEV. J. 439 (1987).

216. 72 B.R. 789.

217. *Id.* at 795. *See also Landscaping Servs.*, 39 B.R. at 591 (examiner charged with investigating whether the confirmation standards had been met as well as the debtor's good faith); *In re* Apex Oil Co., 92 B.R. 847, 851 (Bankr. E.D. Mo. 1988) (examiner investigated proposed sale of assets to insiders).

218. *UNR Indus.*, 72 B.R. at 791-92.

219. *Id.* at 793.

220. UNARCO Bloomington Factory Workers v. UNR Indus., Inc., 124 B.R. 268, 271 (Bankr. N.D. Ill. 1990).

221. *See, e.g., Public Serv. Co.*, 99 B.R. at 182 (examiner appointed to mediate the effort to arrive at a consensual plan of reorganization).

222. *See In re* Carnegie Int'l Corp., 51 B.R. 252, 254 (Bankr. S.D. Ind. 1984).

223. *See, e.g., Boileau*, 736 F.2d 503; *John Peterson Motors*, 47 B.R. 551.

Sections 363[224] and 364[225] provide the limits on the general operational authority of management[226] of the corporate debtor in possession. Section 363 generally provides that the debtor in possession may enter into transactions affecting the property of the estate and may use property of the estate, without notice and a hearing, so long as such transaction or use is "in the ordinary course of business."[227] Section 364 provides the same rule for financing.[228] Executory contract assumptions always are subject to the court's approval.[229] A corporation may enter into transactions other than in the ordinary course of business; however, the corporation may conclude these transactions only with the approval of the bankruptcy court.[230] In defining this limit, the Code allocates decisionmaking authority between the management of the business and the court in its dispute resolution role.

Courts have developed a two-part test to determine whether a transaction is entered in the ordinary course of business.[231] The test focuses on both prior practice of the debtor[232] and what is ordinary in the debtor's industry.[233] Management's actions must meet both prongs of the test.[234]

The ordinary course of business limit provides a relatively good mechanism to allocate decisionmaking along tactical and strategic lines. Not all decisions are significant. Owners have agreed in their contracts to allow management significant discretion over the normal operations of the business, and the bankruptcy process should, to a certain extent, respect this allocation of authority. As decisions become more significant, however, the lack of a complete set of governance controls requires increased judicial scrutiny.[235]

One area in which courts provide such scrutiny is the financing of the corporation during the Chapter 11 process. As noted earlier, financing arrangements may involve significant asset deployment and financial restructuring issues that cannot be addressed through the normal negotiation process.[236] Courts have recognized this fact most directly in analyzing lending

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224. 11 U.S.C. § 363 (1988).
225. 11 U.S.C. § 364 (1988).
226. The Code's general authorization to operate the business is contained in 11 U.S.C. § 1108 (1988), which provides, "Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business." 11 U.S.C. § 1107(a) (1988) allows the "debtor in possession" to exercise all of the rights, powers, and duties of the trustee. If the debtor in possession is a corporation, management exercises this authority. *See* Nimmer & Feinberg, *supra* note 2, at 23.
227. 11 U.S.C. § 363(c)(1).
228. 11 U.S.C. § 364(a).
229. 11 U.S.C. § 365.
230. 11 U.S.C. § 363(b)(1); 11 U.S.C. §364 (b),(c) & (d).
231. *See, e.g.*, United States *ex rel.* Harrison v. Estate of Deutscher, 115 B.R. 592, 598 (M.D. Tenn. 1990); *In re* Dant & Russell, 853 F.2d 700, 704 (9th Cir. 1988); *Johns-Manville*, 60 B.R. at 616-18.
232. This aspect of the test of ordinariness is known as the "vertical dimension or creditor's expectation test." *See Johns-Manville*, 60 B.R. at 616.
233. This test is called the "horizontal dimension or industry-wide test." *See id.* at 618.
234. *See Dant & Russell*, 853 F.2d at 705.
235. *Cf. In re* Schipper, 933 F.2d 513, 516 (7th Cir. 1991); Nimmer & Feinberg, *supra* note 2, at 37, 70.
236. *See supra* text accompanying notes 44-69.

arrangements involving cross-collateralization and other enhancements provided to the existing secured creditor.[237]

In *In re Vanguard Diversified*, the court developed a four-part test for the appropriateness of cross-collateralization clauses:

> (1) Absent the proposed financing, the business operations will not survive...; (2) [the debtor] is unable to obtain alternative financing on acceptable terms...; (3) the proposed lender will not accede to less preferential terms; and (4) the proposed financing is in the best interests of the general creditor body.[238]

The test is widely used by courts in analyzing cross-collateralization clauses.[239]

The *Vanguard* list seems to reflect qualitative rather than governance concerns. Management freed of contractual constraints by the Chapter 11 process is second-guessed by the bankruptcy court[240] as to the need for financing (part 1), their negotiation skills (parts 2 and 3), and their cost-benefit analysis (part 4).

In contrast to the judicial scrutiny of financing decisions, courts give deference to management's decision to assume or reject executory contracts. Courts uniformly state that the decision to assume or reject an executory contract is a matter committed to the business judgment of the debtor's management.[241] Thus, even though the decision is one that may impact the asset deployment and financial restructuring issues facing the business owners,[242] and even though the Code requires judicial approval of the executory contracts decision,[243] courts seem loathe to exercise their authority to scrutinize management's actions in this area.

The final broad area of judicial oversight is the requirement of judicial approval after a notice and a hearing of use, sales, or leases of assets outside

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237. *See generally Emergency Preferential Orders*, *supra* note 53, at 80-85.

238. *In re* Vanguard Diversified, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983).

239. Professor Tabb has, in several articles, fully developed the analysis of preferential clauses (such as cross-collateralization) in financing arrangements. *See Emergency Preferential Orders*, *supra* note 53; *Cross-Collateralization*, *supra* note 56; Charles J. Tabb, *Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma*, 50 OHIO ST. L.J. 109 (1989) [hereinafter *Appealability and Finality*]. Professor Tabb argues that such preferential clauses should be refused in all cases unless Congress tightens procedural and substantive requirements for the judicial approval of such clauses.

240. In most cases, the bankruptcy court will indeed be the final arbiter of the appropriateness of such orders. 11 U.S.C. § 364(e) provides that the reversal or modification on appeal of financing orders will not affect the rights granted to lenders unless such order is stayed. *See generally Appealability and Finality*, *supra* note 239.

241. *See, e.g.*, Lubrizol Enters. v. Richmond Metal Finishers, 756 F.2d 1043, 1046 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986); *In re* Prime Motor Inns, 124 B.R. 378, 381 (Bankr. S.D. Fla. 1991); *In re* Blackstone Potato Chip Co., 109 B.R. 557, 560 (Bankr. D.R.I. 1990); *In re* Southern California Sound Sys., Inc., 69 B.R. 893, 898 (Bankr. S.D. Cal. 1987); *In re* Anglo Energy Ltd., 41 B.R. 337, 340 (Bankr. S.D.N.Y. 1984).

242. *See supra* text accompanying notes 59-65.

243. 11 U.S.C. § 365(a).

of the ordinary course of the debtor's business.[244] Courts, in analyzing these decisions, generally use a sliding scale of review under which they more closely scrutinize the management's business judgment as the significance of the sale increases.

Judicial review in this area also focuses primarily on the qualitative aspects of the decision rather than the governance question concerning which parties are advocating or resisting the sale. In *In re Lionel Corp.*,[245] for example, the Second Circuit reversed the order of the bankruptcy court approving the sale of the debtor's 82% common stock interest in another corporation.[246] In reversing the order, the court provided a list of factors courts should consider in approving sales of substantial assets:

> [T]he proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition..., which of the alternatives of use, sale or lease the proposàl envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value.[247]

Many of these factors seem to relate to the quality of the business decision to sell the assets.[248]

The effectiveness of judicial approval of specific decisions as a means of controlling managerial behavior is limited by several pragmatic considerations. The most obvious of these limitations is time. Decisions in Chapter 11, like any other business decision, must be made in a timely manner. Participants in the bankruptcy process usually do not have the luxury of the many months (or even years) the adversarial process typically requires for decisionmaking. Business decisions such as these may be mooted by complete business failure if they are not made quickly.

A difficulty created in part by the lack of time is the problem of inadequate information. Owners wishing to contest managerial actions normally are not afforded the opportunity to engage in the fact-finding typical in other

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244. 11 U.S.C. § 363(b).
245. 722 F.2d 1063 (2d Cir. 1983).
246. *Id.* at 1064.
247. *Id.* at 1071.
248. In addition to the general qualitative concerns expressed by the *Lionel* court, courts have further limited large asset sales in situations in which the sale constitutes a *sub rosa* plan of reorganization. *See, e.g., In re* Continental Air Lines, Inc. 780 F.2d 1223 (5th Cir. 1986); *In re* Braniff Airways, Inc. 700 F.2d 935 (5th Cir. 1983), *reh'g denied*; 705 F.2d 450 (5th Cir. 1983). *See also* Nimmer & Feinberg, *supra* note 2, at 15-20. The courts in these cases approach the question of asset sales from a governance perspective by looking to the effect of the transaction on asset deployment and financial restructuring issues. The judicial reaction to these sales has been to require the issue to be determined within the plan process. *See Braniff*, 700 F.2d at 940 ("The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets."). This reaction may lead to an inability of the owners to structure a rational business transaction with a third party. *See supra* text accompanying notes 28-43 for an analysis of the plan process.

adversarial processes. Judges, therefore, may be presented with an incomplete or one-sided version of the facts necessary for rational decisionmaking.

Finally, although judicial review of particular decisions provides some degree of control over managerial conduct when the conduct is affirmative, the system may not address management's failure to act. Managers, by virtue of their role in the debtors' day-to-day operations, have complete threshold authority to determine whether to sell assets, seek financing from sources other than the existing secured creditor, or seek less expensive replacements for existing contractual arrangements. Unless the court is presented with a fully negotiated deal, there is nothing to approve.

This is not to say that other parties may not undertake to negotiate such transactions and seek court authorization and direction to the debtor's management to complete the transaction. The Code leaves managers in control, but not in exclusive control. Other parties in interest may seek specific actions through motions requesting relief from the automatic stay,[249] conversion of the case to one under Chapter 7,[250] or through the general authorization to raise and be heard on any issue in the case.[251] The problems with this method of assumption of control are two-fold. First, management may enjoy informational advantages over these other parties. Second, third parties may be unwilling to subject a fully negotiated transaction to the whims of a bankruptcy court in an adversarial setting.

The representational structures and judicial controls provided by the Chapter 11 process, therefore, may provide an inadequate replacement for the market and contractual controls suspended during the case. Representation can go only so far in the absence of effective means of controlling managers. General judicial controls cannot be expected to provide true controls over managerial actions because of the extreme nature of the remedy and the countervailing need to provide managers some discretion over the corporation's business operations. Finally, judicial control over specific decisions is unsatisfactory because it applies an adversarial process to what are essentially business decisions. Full replacement of contractual and market controls is certainly unrealistic given the pragmatic concerns of the process, but perhaps we can come closer.

IV. THE PROBLEM WITH INADEQUATE MANAGERIAL CONTROLS

Bankruptcy engenders a near complete breakdown of the status quo. Most of our general assumptions about business liabilities are shaken to their very core by a realization that assets are simply insufficient to cover liabilities. Bankruptcy changes the rules in a number of areas. Why should governance be any different?

Bankruptcy is indeed a unique process and special rules obviously must apply, but governance issues present substantially the same problems inside

249. *See* 11 U.S.C. § 362(d) (1988).
250. *See* 11 U.S.C. § 1112(b) (1988).
251. *See* 11 U.S.C. § 1109(b) (1988).

and outside of bankruptcy. The same conflicts among owners and between owners and managers existing outside of Chapter 11 exist inside the process. If anything, the immediacy of these conflicts is aggravated by the crisis atmosphere surrounding the proceedings. The question is simply whether management is particularly well positioned to respond to the needs of all of the participants even without a complete set of governance controls. The answer requires an examination into the potential conflicts present in a reorganizing business, and management's incentives in resolving these knotty problems on a day-to-day basis.

Consider first the general incentives of the owners above and below the line of insolvency. The owners with a priority so low that they likely would receive no distribution under the absolute priority rule under any scenario of asset deployment, herein called "junior owners," most likely have an incentive to continue the operations of the business regardless of economic realities. Because a liquidation of the corporation will reveal the inadequacy of the assets to pay all prior claims, their securities are worthless under such a scenario. This harsh fact obviously will color their views regarding the fundamental issues arising during the reorganization process.

The junior owners can be expected to opt for financing on any terms available regardless of the possibility that such a course of action may amount to throwing good money after bad. This group probably holds similar views regarding the assumption of executory contracts necessary to the business operations. Junior owners may resist sales of business assets because such sales set the value of the assets sold and therefore limit the leverage of this group during the plan negotiations.[252] On almost any issue, junior owners will have an incentive to argue for the result that prolongs the reorganization and keeps as many assets together as possible.[253]

Next consider the group holding a priority which will yield full payment on the liquidation of the business, the "senior creditors." Obviously, this group will view the liquidation of the business as a desirable result regardless of the existence of positive going concern value. Going concern value will not benefit the senior claimants,[254] but they may bear the cost of a failed attempt at reorganization. This fact will create an incentive to argue for the liquidation of the business on an expedited basis. Thus, senior owners may be expected to argue against financing the business operations on any terms and to argue for the rejection, or assignment, of executory contracts needed to operate the business and the sale of assets.[255]

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252. *See supra* text accompanying notes 28-43.

253. "[G]eneral creditors and shareholders (who often have more to gain than to lose from delay) may tend to be excessively optimistic and opt for reorganization when it is unwarranted." JACKSON, *supra* note 35, at 189.

254. The corollary to the absolute priority rule will prohibit this group from receiving more compensation from the reorganization than the amount of their claim. *See supra* note 36 and accompanying text.

255. This categorization admittedly does not take into account owners with incentives outside of those provided by their ownership interests. For example, employees may have prepetition wage claims that are of a priority to insure full payment in a liquidation. *See* 11 U.S.C. § 507(a)(3) (1988) (providing a priority for certain prepetition wage claims). These employees may not necessarily be expected to see the liquidation of the business as being in their

Somewhere in between falls the group that likely will be paid something upon the liquidation of the business but likely will not be paid in full under any scenario, the "residual owners." Like the residual owners outside of bankruptcy, this group will approach decisionmaking on a true cost-benefit basis.[256] Residual owners will decide their position on financing, the assumption-of-executory-contracts and asset-sales issues on a case-by-case basis since they will stand to benefit from correct decisions and to lose from incorrect decisions.[257]

Somewhere in this morass of conflicting incentives lies management. If management can be expected to find and align itself with the residual claimants, the reorganization should proceed on a more rational economic basis. If, on the other hand, management's allegiances lie with junior or senior owners, the perverse incentives held by the group may carry over to the decisions made by management, perhaps setting an economically irrational course for the reorganization.

Management alignment may be based on a number of factors the overall effect of which is difficult to determine. Members of management themselves may have an interest in retaining their jobs for as long as possible because of their high level of firm-specific skills.[258] As Professor Tabb has pointed out, "management decisions almost inevitably are biased in favor of survival."[259] This bias normally will cause management to align itself with the interests of junior creditors and may result in management actions that have the effect of prolonging the reorganization at all costs.

Obviously, this bias is directly increased by the extent to which managers are also junior owners.[260] In small, closely held corporations, owner-managers may have most of their personal wealth tied up in the corporation.[261] If a liquidation will result in the elimination of that wealth, managers in this situation will understandably seek to avoid such a result.[262]

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best interests, however. Groups such as this can be expected to have clear incentives that may be unrelated to the economic realities at issue in the business decisions. Thus, by broadening the analysis to include these other incentives, these groups may be classified along the lines proposed here.

256. *See supra* text accompanying notes 79-80.

257. "The difficult question is not one of a conflict of principles but rather one of ensuring that the residual class — the unsecured creditors — make the decision whether acquiescence in the demand is in their interests or not." JACKSON, *supra* note 35, at 158.

258. *See supra* text accompanying notes 100-02. Unlike management in a solvent corporation, managers of failed corporations also may have a general incentive to increase enterprise risk. If managers risk losing their jobs during the reorganization process, they may be more likely to gamble with estate assets hoping for a result that will give them the status of heroes.

259. *Emergency Preferential Orders*, *supra* note 53, at 79.

260. *See* Nimmer & Feinberg, *supra* note 2, at 38-41.

261. *Id.*

262. Nimmer and Feinberg draw a distinction between sole proprietorships and closely held corporations. When analyzing governance issues involving the sole proprietorship, they expect and condone a certain amount of owner self-interest because these reorganizations implicate the "fresh start" policy of the Code. In closely held corporations, however, because the owner-managers have not submitted to all of the burdens of the bankruptcy process, they should function as a fiduciary to the estate. *Id.* The question that remains, however, is whether the Chapter 11 governance system is adequate to insure that managers of close corporations will act in such a manner.

Of course, this bias and the ability of management to act on it are not inevitable. One can envision cases in which managers would find their reputation enhanced by an orderly liquidation rather than a messy attempt at reorganization that ultimately fails. Also, in large cases with active creditors' committees, creditors may have adequate leverage to counteract any bias of management.[263] In their ground-breaking empirical study of large public corporations, Professors LoPucki and Whitford found that "[t]he leverage available to managers in large reorganization cases is not necessarily exercised in favor of shareholders."[264] Thus, one cannot assume that managers will always hold incentives that conflict with those held by the residual claimants.

The size of the case may impact the effectiveness of the creditors' committee and the general ability of management to raise itself above the fray and act with independence for several reasons. Large cases in which hundreds of millions of dollars are at stake will likely support a much more active creditors' committee. The estate may be large enough to allow the committee to appoint accountants and financial advisors as well as batteries of attorneys whose full attention will be devoted to monitoring the case.[265] In addition, the fact that the case involves a large corporation likely will mean that there will be creditors with claims of a magnitude to warrant the investment of managerial time and attention needed for effective committee participation.[266]

Large cases also may provide management some degree of insulation from the pressures exerted by the shareholders. The management autonomy created by a separation of ownership and control outside of bankruptcy[267] may exist inside of bankruptcy,[268] particularly if no equity committee is

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263. Professor Michael Gerber cites two cases in which the creditors' committee was successful in controlling management. In the reorganizations of both the Lionel and Johns-Manville corporations, the replacement of two top officers was linked to pressure from creditors. Gerber, *supra* note 131, at 348.

264. LoPucki & Whitford, *supra* note 4, at 150. Professors LoPucki and Whitford have promised a separate article on the questions of how much leverage management has in large cases and how they use it. *Id.* at 155 n.63.

265. 11 U.S.C. § 1103(a) (1988) allows the committee, with the approval of the court, to employ professionals to assist it in carrying out its functions. Professionals are compensated out of the estate as priority administrative expenses. 11 U.S.C. §§ 328, 503 (1988). This payment assumes that the estate will have sufficient assets to make the payment, however. Further, requests for compensation are subject to review by the court for reasonableness. *Id.* § 328.

266. The recent explosion in "claims trading" (i.e. purchasing claims against a Chapter 11 debtor) may provide additional benefits in this regard. A claims buyer may have sufficient capital invested in the corporation to warrant the buyer's undertaking of a significant role in the Chapter 11 process. *See* Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 6-7 (1990). On the other hand, this phenomenon may have ill effects since those buying claims may avoid participation through the committee structure because of the heightened duties of committee members. *Id.* at 115.

267. *See supra* text accompanying notes 80-82.

268. Of course, if the bankruptcy court exercises its discretion to enjoin shareholders' meetings, management's insulation from shareholders will be on the same level as its autonomy from creditors. *See supra* text accompanying notes 136-48. To the extent that corporations in Chapter 11 are presumed to be insolvent, this result is appropriate. *See supra* text accompanying notes 124-29.

appointed.[269]

The creditors may have less ability to control management in reorganizations of smaller corporations. Because fewer dollars are at stake, creditors may lack the incentive to make the commitments of time and attention required to monitor and control management. Also, the estate may not be of sufficient size to support the professionals necessary to assist the creditors' committee in offsetting management's control.

Studies bear out the premise that creditor control is not an effective counterbalance to managerial incentives in smaller cases. In a study of Chapter 11 cases filed in the Western District of Missouri during the period between October, 1979 and October, 1980, LoPucki found that Chapter 11's procedural mechanisms to control management failed to achieve their intended purpose.[270] The study included forty-eight Chapter 11 cases involving businesses with scheduled assets ranging from a high of $15 million to one business with no scheduled assets.[271] Most of the cases studied involved small debtors.[272]

LoPucki's data revealed that creditors' committees were appointed in "a minority of the cases"[273] and that these committees "usually failed to obtain assistance from an attorney, accountant, or other person familiar with the reorganization process."[274] The data also disclosed that examiners were seldom appointed and that trustees were appointed only after the debtor had abandoned the business.[275] Overall, the data led LoPucki to conclude that "[t]ogether the effect of these system failures was that the debtors studied were able to continue in complete control of their businesses while they were under the jurisdiction of the court."[276] Later studies have indicated a similar lack of effective controls on managerial behavior.[277]

The analysis thus far has seen bankruptcy as a simple extension of the problems facing corporate owners generally. In reality, the problems created by financial failure affect a dramatically larger group. The specter of bankruptcy conjures up images of lost jobs, idled plants, and failure of many other small businesses that had come to rely on the failed company as a source of supply.

The extent to which a bankruptcy system can or should accommodate these other very real effects of business failure has been a matter of recent

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269. *See supra* text accompanying notes 163-65.

270. Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code? — First Installment*, 57 AM. BANKR. L.J. 99 (1983) [hereinafter *Debtor in Full Control I*]; Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code? — Second Installment*, 57 AM. BANKR. L.J. 247 (1983) [hereinafter *Debtor in Full Control II*].

271. *Debtor in Full Control I*, *supra* note 270, at 120-21.

272. Only 11 companies studied had assets in excess of $1 million. *Id.*

273. *Debtor in Full Control II*, *supra* note 270, at 272.

274. *Id.*

275. *Id.*

276. *Id.*

277. *See* Kerkman, *supra* note 159.

debate.[278] One school of thought, led by Baird and Jackson, sees bankruptcy as a collective debt collection device in which the relative non-bankruptcy rights of all of the participants in the business enterprise should be respected. Perhaps employees, suppliers, and consumers should have rights that may be affected by the reorganization, but those rights are properly the subject of non-bankruptcy law.[279] The introduction of new rights in a bankruptcy case can only lead to forum shopping and a consequent decision to use the bankruptcy process when it is not the best method of resolving the problems facing the company.[280]

The alternative view, most recently championed by Professor Elizabeth Warren, rejects this elegant view of the process as being too simplistic.[281] A firm's failure implicates many interests beyond those faced by nonbankrupt companies. Bankruptcy is viewed as a loss distribution device necessitated by a generalized contractual breakdown that state law rights cannot, and were not intended to, accommodate.[282] This view leaves room for consideration of the effect of the process on groups that are not technically creditors or shareholders.[283]

A concern regarding the analysis of the bankruptcy governance framework set out here may be that it fails to take into account these other constituencies affected by the reorganization process. The ineffective control over managers by the corporate owners may result in a failure to maximize value, but value is only one piece of the puzzle. If management has incentives to at least attempt reorganization, everyone may be better served. Management's incentives may save jobs or at least delay the liquidation, thereby softening the landing.

One response to this concern is that the question of what interests bankruptcy should protect is one that deserves full philosophical debate. It is not a question to be submerged in the quagmire of bankruptcy decisionmaking. As a purely descriptive matter, the general corporate reorganization provisions of the Code do not take account of non-owner interests.[284] In general, the Code speaks in terms of creditors and interest holders and not in terms of communities or dependents. Still, bankruptcy judges sometimes take the public interest into account in their decisions on specific questions,[285] and

278. This debate is set forth in particularly sharp focus in Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); and Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: a Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

279. *See* Baird, *supra* note 278, at 822-24.

280. *Id.* at 824-26.

281. *See* Warren, *supra* note 278, at 797-800.

282. *Id.* at 789-93.

283. *Id.*

284. *Cf.* 11 U.S.C. § 1165 (1988). Subchapter IV of Chapter 11 governs railroad reorganizations. Section 1165, contained in Subchapter IV, specifically requires the court and trustee to consider the public interest in considering many of the fundamental issues arising in railroad cases. Section 1165 has no counterpart in the Code's provisions governing general corporate reorganizations.

285. *See, e.g.*, *Ionosphere Clubs*, 113 B.R. at 170-71.

Congress, in enacting the Code, amply illustrated its concern with jobs and community dependents.[286]

The extent to which judicial philosophy is geared toward the protection of parties other than creditors and shareholders will never be known as long as the courts are not forced to make decisions on the basis of protecting these non-owner interests. At least facially, most opinions look to the specific effect of the decision on the creditors and shareholders of the business and not to the other interests affected by the outcome. If the protection of non-owner interests is driving judicial decisions within the governance framework, that motivation should be directly stated.

Even if the analysis starts with the proposition that the reorganization process should take the interests of the broader community into account, the governance system produces problems. One cannot assume that management, acting in its own self interest, necessarily will take actions that are consistent with the broader goal of distributing the losses occasioned by the collapse of the corporation. Even if one assumes that management's incentives will be directed toward the continued operation of the business, one cannot extend the analysis further to assume that the reorganization process is the best method available to distribute losses among the wide range of participants. These other interests should be served by a system that takes direct account of all of the losses caused by the business failure and balances the losses of non-owners directly against those of the owners. Management may not be the best group to undertake such a balancing.

V. A PROPOSED BANKRUPTCY GOVERNANCE MODEL

A tension between pragmatism and theoretical economic efficiency pervades the problem of corporate governance in Chapter 11. Although management may be the group best suited to run the business from a practical perspective, individual managers may hold incentives that are inimical to the goal of maximizing the value of the business assets. One must tread lightly over this minefield.

The Code's bias in favor of the continuation of existing management is evidence of this tension. One of the most controversial issues facing the drafters of the Code was whether a trustee should be required in cases involving "public" companies. Like many of the issues arising in the bankruptcy arena, the question is one of the need for representation of interested parties and the complete elimination of conflict versus the pragmatic need for speedy and simplified procedures for the reorganization of troubled companies. After some back and forth debate between the House and the Senate, Congress opted for leaving the operation of the business with the debtor in possession, and, for the most part, the approach has been useful in streamlining the process.

Leaving operational control with the prepetition managers makes sense for several reasons. Management is familiar with the business operations and has information necessary to the operation of the business that may not be

286. *See* H.R. REP NO. 595, 95th Cong., 1st Sess. 220 (1977).

found in the business records. The appointment of a trustee may cause a delay in the progress of the case while the trustee gathers information necessary to the fulfillment of his or her duties. Further, the loss of all control over the course of the bankruptcy case may create a disincentive for managers to file a bankruptcy petition even when bankruptcy is the most effective means of sorting out the problems of business. Thus, managers should be left in at least operational control of Chapter 11 debtors.

For the most part, a structure for controlling managerial behavior exists in Chapter 11. Because the contractual aspects of the non-bankruptcy governance system must be suspended in bankruptcy, the process must rely to a large extent on judicial controls over managerial actions. Chapter 11 provides ample opportunity for judges to exercise that control.

This Article is not intended to advocate any structural changes to the Code's governance mechanism. Instead, what is needed is simply a shift in attitude. Courts should recognize that fiduciary duties and the mechanisms available to replace managers are insufficient to control managers fully. Outside of bankruptcy, fiduciary duties compose only one part of a broader governance framework, much of which is suspended during the pendency of the Chapter 11 case. Given the suspension of contractual aspects of the non-bankruptcy governance system, courts must realize that management is placed in a position of autonomy, particularly in smaller cases in which no active creditors' committee exists.

To some extent, courts can counteract this autonomy through the approval processes required for fundamental corporate transactions entered during the case. In making a decision whether to approve such a transaction, courts should be sensitive to the fact that what they are facing is in large part a governance question. The group seeking approval of transactions involving financing, the assumption of executory contracts, and asset sales is as important as a judicial determination of the qualitative aspects of such transactions. The question is not so much whether a decision is correct as it is to whom to listen in making the determination.

Corporate governance principles existing outside of the Chapter 11 process suggest an approach to judicial decisionmaking that revolves around the court's view of where the residual claims lie. If courts could locate the group holding the residual claims and give more weight to that group's view of the particular decision at issue, courts could provide a rough substitute for the contractual and market aspects of the governance system.

The problem that remains is finding the group. The question involves the determination of asset values and amount of liabilities — complex problems to which much of the bankruptcy process is devoted. Although this complexity may render such an analysis ineffective as a total solution to the problems of governing the corporation in Chapter 11, it does not necessarily render such a approach completely devoid of usefulness.

In many cases, general observations may provide estimates of asset values that are at least reliable enough to make clear that certain parties may occupy the role of senior or junior owners even if the exact group holding residual claims is not as definite. If a case involves a corporation that is clearly insolvent, common stockholders' views on the desirability of a particu-

lar transaction involving asset deployment and financial restructuring issues should be discounted in favor of the views of the general unsecured creditors. Similarly, a fully secured creditor's insistence upon a course of action that may result in the cessation of business operations should be provided less weight than a creditors' committee's opposition to that action.

This approach would require a court to consider the debtor's solvency in its analysis of contested business decisions. Parties could put on proof of asset values and liabilities in order to support or attack a particular decision. For instance, this approach would allow a creditors' committee to show that the shareholders occupy the role of junior claimants and that the shareholders' views on the need for a particular financing transaction, therefore, should be discounted. Also, if the committee could show that the unsecured creditors represented by the committee occupy the role of residual claimants, the court should afford the committee's views greater weight.

Recognizing the difficulty of determining where the line of solvency should be drawn, the court's consideration of the issue should be only a factor in its decision. Courts already are using multi-factored analyses in considering asset sale and financing issues. While executory contract decisions currently are not subject to particularly strict scrutiny, similar standards can and should be used. Determining which group holds the residual claims could be fit within the mix of factors for all of these decisions.

The weight given to this factor should increase as the clarity of the proof regarding solvency increases. Some cases may lend themselves well to the analysis from early on in the proceedings. In more cases, asset values will be less clear. In such cases, the residual claim analysis may be most useful as an exclusionary factor rather than a controlling factor. It likely will be easier for a court to conclude that a particular group, shareholders, for example, is not composed of residual claimants than it is to find that another group is. In this sense, the residual claim analysis normally should be used to require simply that the views of the junior or senior owners be supported by more compelling proof of business justification.

Of course, there are cases in which the residual claim analysis will not point the court in a clear direction. In such cases, courts may be unable to make even a rough estimate of the group holding residual claims or may find no clear support or opposition from the owners of the corporation to a particular management proposal. In these cases courts must necessarily explore qualitative aspects of the decisions because of the possibility that management's incentives are aligned with those of a group which does not stand to gain or lose from the particular decision.

The decisions in these cases also may be accompanied by more general governance problems. A lack of clear direction from owners and inability to find the corporation's residual owners may infect the entire process and raise managerial autonomy to its highest levels. Judicial supervision may be the last hope for realistic control over the process.

Providing judicial controls over managerial behavior in this environment places a good deal of strain on judicial resources, however. Bankruptcy courts, like any other court, must rely on adversarial processes to develop the full range of facts and options before realistic judicial oversight can occur. To

the extent that a case is too small to warrant significant owner participation in this process, managers will win by default. One obvious solution to this problem is the appointment of a trustee by the court. As discussed above, however, such a course eliminates many benefits of the current process.

The appointment of an examiner may be a useful middle ground between leaving management in unfettered control and the replacement of management with a trustee. Courts can leave management in operational control, thus reaping the benefits of managerial continuity, while using an independent fact-finder for selected issues. When the court is uncomfortable with the controls over management in a particular case, an examiner may be an effective voice in the case.

A few courts already have discovered the advantages of granting an examiner powers going beyond investigation of possible wrongdoing by parties to the case. Several courts have granted examiners the authority to mediate disputes, bring suits, and operate the debtor's business.[287] The selective use of examiners to assist the court in remedying particular governance problems may be a growing trend.

Examiners, like trustees, are not without costs. Again, pragmatism often will impair the full vindication of rights that may be adversely affected by management control. The problem may be particularly acute in smaller cases. Because smaller cases result in inadequate creditor participation, the governance problems may be greater. At the same time, smaller cases may not have adequate assets to support the fees an examiner may require.

Effective investigation by an examiner need not require full batteries of lawyers and accountants in small corporate cases, however. Most of the issues with which this article is concerned are purely business issues relating to the appropriate deployment of assets. A selective use of an examiner as an independent fact-finder on these business issues may not be prohibitively expensive. The examiner may counteract the control of management in these decisions simply by presenting to the court a contrary view.

CONCLUSION

Business failure brings the divergent economic incentives of the business owners directly into conflict. In all corporate settings, creditors with fixed-return contracts seek to minimize the risk of the business entity while stockholders may have an incentive to increase overall risk. Nowhere is this conflict more apparent than in the reorganization of an insolvent corporation. Creditors with a priority in assets will insist on a course of action that minimizes the risk that the asset values required to insure payment will not be realized. If liquidation of the corporation's assets will provide the senior creditors payment in full, these creditors will find an immediate sale to be in their best interest. Equity owners who may not participate in any distribution of assets on the liquidation of the insolvent corporation will seek to delay the liquidation and withdrawal of capital as long as possible. Through delaying a liquidation of the business assets, shareholders may capture some of the cor-

287. *See supra* text accompanying notes 214-22.

poration's value. The continuation of the business increases the risk that the asset values may deteriorate. This risk is borne by those creditors whose priorities would have assured them payout if the business had been immediately liquidated.

Many decisions faced by the managers of a Chapter 11 debtor in possession involve choices that implicate the conflicting incentives of claimants with differing priorities. Transactions such as the sale of assets, financing, and the assumption or rejection of executory contracts raise issues that directly bear upon the risk of the business entity. These transactions are of such weight and character that they ultimately may determine the course of the bankruptcy case and the postpetition character of the debtor.

Much of the debate surrounding these decisions has focused on qualitative aspects. This focus is misplaced. Like any other business, a corporation in Chapter 11 is faced with many possible courses of action, each of which is necessarily uncertain. Corporate law has recognized the difficulty of determining whether corporate officers and directors have made "correct" decisions. The law of corporate governance instead focuses on the agency relationship, providing standards by which the agent may be judged and a means through which the agent may be removed and replaced. Thus, the law's role in corporate decisionmaking is relegated to the process of decisionmaking and not to the quality of decision. To the extent possible, decisionmaking in bankruptcy should be no different.

The Bankruptcy Reform Act of 1978 dramatically changed the governance of corporations reorganizing under its provisions by eliminating the requirement of a mandatory independent trustee. The chief purpose behind the presumption that the debtor's management would continue to run the business was to reduce the disruption of the general business operations throughout the reorganization process. The concept of a "debtor in possession" left management with far broader powers, however.

Under the Code, management is the focal point for strategic decisions faced by the Chapter 11 debtor. This role provides management the ability to subtly influence the fundamental decisions directly affecting the deployment of the business assets and the ultimate distribution of those assets or of claims against those assets. Management's informational advantages, together with this influence, provide a high degree of leverage over the prepetition owners and claimants.

This control and leverage is similar to that existing in solvent corporations outside of Chapter 11. The complexity and size of modern corporations often require some degree of separation of control from ownership. Courts, legislators, and commentators have long struggled over the governance problems created by this separation. Corporate law provides a governance structure for the resolution of these problems that incorporates legal, contractual, and market constraints into an integrated system that addresses most of the problems created by the need to separate decisionmaking from ownership.

Importing general corporate governance principles into bankruptcy provides an incomplete solution to the special problems facing creditors and equity owners of a corporation operating under Chapter 11. The creditors' inability to enforce their contractual protections and the resulting lack of mar-

ket discipline eliminate important protections not adequately addressed by the court's extension of management fiduciary duties to them. Alternatively, if management perceives its interest to be more closely aligned with the senior creditors, junior creditors and equity holders may find themselves without an effective voice in the reorganization process.

These difficulties go beyond issues of creditor/shareholder protection and fairness to reach to the economic justification for reorganization. If bankruptcy is believed to be simply a process for redeployment of assets and redistribution of claims against those assets on an economically efficient basis, management control and allegiances may introduce opportunities for strategic behavior that is inconsistent with the rationale of the process. Corporations that economically should be liquidated may be reorganized and vice versa. If, on the other hand, bankruptcy is viewed as a means through which losses can be distributed to pre-bankruptcy claimants while the corporation undergoing the process stays in business and continues to contribute to the community through providing employment, paying taxes, etc., the same strategic influences may infect the process.

The solution to these difficulties requires little structural reform. In many cases, courts may be able to approximate the non-bankruptcy governance system by including a determination of the corporation's asset value in the other factors they use to evaluate contested business decisions. By determining the asset value, courts may determine which group holds the residual claims on the corporation's assets. Like the non-bankruptcy system, the court could then give the views of that group on the business decision the most weight in the decision making process.

In addition to this approach, courts should continue to rely on the advantages an impartial third party may bring to the reorganization process. Courts have broadened their use of examiners to provide a middle ground between extreme alternatives of appointing a Chapter 11 trustee and continuing the debtor in full possession. The Code's drafters' desire to provide continuity of management in the day-to-day operations of the business has been realized and has been successful. However, the appointment of an examiner to monitor management's operation of the debtor, to serve as a focal point for negotiations over fundamental transactions, and to offset the informational advantages of management can do much to counterbalance the managerial control that has come to characterize Chapter 11.