Kentucky Law Journal

Volume 93 | Issue 4 Article 2

2005

The "New and Improved" Chapter 11

Stephen J. Lubben
Seton University

KENTUCKY
LAW JOURNAL

VOLUME 93 2004–2005 NUMBER 4

ARTICLES

The "New and Improved" Chapter 11

BY STEPHEN J. LUBBEN*

Professor Lubben presented his article, The "New and Improved" Chapter 11, *at the Annual Meeting of the Association of American Law Schools, Creditors' and Debtors' Rights Section, on January 8, 2005, in San Francisco, California. Commenting on the article were Professors Douglas G. Baird, University of Chicago Law School, Robert K. Rasmussen, Vanderbilt Law School, and Jay L. Westbrook, University of Texas Law School. Professor Lubben's article was chosen for presentation from papers submitted to the Section in response to its nationwide call for papers.*

* Associate Professor of Law, Seton Hall University School of Law. Douglas G. Baird, Robert K. Rasmussen, and Jay Lawrence Westbrook generously provided thoughtful responses to this paper when I presented it at the American Association of Law Schools' annual meeting in San Francisco, and the final product benefits from their comments. Many thanks also to Peter Clapp, Timothy Glynn, Richard Levin, R. Erik Lillquist, Lynn LoPucki, David A. Skeel, Jr., Elizabeth Warren, and Jennifer Ruth Hoyden for their thoughts on earlier iterations of this paper. This paper was supported by a grant from Seton Hall University School of Law.

INTRODUCTION

Chapter 11 has healed itself.[1] According to some of its leading critics, chapter 11 is no longer the long, expensive process that it was in the 1980s,[2] when storied companies like Pan Am slowly wasted away their remaining value in vainglorious attempts to survive in a changed marketplace.[3] Today's chapter 11 is a swift, market-driven process that quickly moves troubled companies into more capable hands.

The credit for chapter 11's cure can be traced to improved markets for distressed assets, reduced use of firm-specific assets, and experience, but most of the credit goes to control rights.[4] In particular, advances in financial contracting are said to allow the parties to agree "about who should exercise control over the firm's assets in any particular state of the world."[5] Most often these control rights are exercised by a DIP lender[6] who will take charge of the debtor upon its financial collapse.[7] As neatly summarized by two proponents of the control rights theory: "Corporate reorganizations

---

[1] *See* 11 U.S.C. §§ 1101–1174 (2000).

[2] *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 758–59 (2002) (describing the influence of railroad bankruptcies on the reorganization process) [hereinafter Baird & Rasmussen, *End of Bankruptcy*]; Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787, 1808 (2002) (attributing the speed of Enron's asset sales in chapter 11 as a "testimony to the flexibility and creativity of the modern bankruptcy bench") [hereinafter Baird & Rasmussen, *Lessons*]; David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 917 (2003) ("A decade ago, many observers believed that Chapter 11 was irretrievably flawed.") [hereinafter Skeel, *Creditors' Ball*].

[3] *See* Pan Am Corp. v. Delta Airlines, Inc., 175 B.R. 438 (S.D.N.Y. 1994) (describing the failed efforts to reorganize Pan Am).

[4] As defined by Baird and Rasmussen:

> Control rights allocate decisionmaking authority over the firm's assets and by their nature are more complex than cash-flow rights. Cash is a single metric; control is not. Control is the ability to make decisions regarding the deployment of assets, including human capital. These include decisions both large and small. They can range from the decision to merge with another firm, to stop producing a current product, to change suppliers, and so on.

Baird & Rasmussen, *End of Bankruptcy*, *supra* note 2, at 779.

[5] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805.

[6] A DIP lender is a debtor-in-possession or post-bankruptcy lender who provides financing to the debtor during the chapter 11 case. *See* 11 U.S.C. § 364 (2000) (authorizing the DIP to incur new debt); *see generally* George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 901–03 (1993).

[7] *See* Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805 ("In the case of a large firm in bankruptcy, we find that, at the moment Chapter 11 is filed, a revolving credit facility is already in place that entrusts decisionmaking authority to a single entity. This entity will often step in and replace management. It will make the necessary operational decisions before Chapter 11 begins.").

today are the legal vehicles by which creditors in control decide which course of action—sale, prearranged deal, or a conversion of debt to a controlling equity stake—will maximize their return."[8]

The control rights turn that chapter 11 has allegedly taken represents a partial return to the days of the railroad receiverships, which were characterized by strong "control rights given to the investment bankers."[9] While this heritage alone should give us pause, as the receiverships were of dubious efficacy,[10] I ask the reader to put these doubts temporarily to one side.

Assume for a moment that it is possible to contract for control to the extent these authors theorize. Chapter 11 has then become a system of corporate reorganization that is dominated by a single creditor, or at least a small group of sophisticated creditors. Is this a good thing? Speed of resolution is the obvious benefit, and the reason why these leading scholars believe that chapter 11 is much improved. But what are the costs?

I begin this paper by addressing two basic questions. First, should chapter 11 be dominated by a parochial group? And second, who might suffer under such a regime? In particular, I look at whether chapter 11 is appropriately deployed to address a firm's financial distress when that firm has already allocated its control rights to a single actor or a concentrated group of actors, like a DIP lender. Unlike Baird, Rasmussen, and Skeel before me, I express some skepticism about the new state of affairs. While these authors have performed an extremely valuable service by spotlighting the importance of lender control in modern chapter 11 cases, and the companion fact that the priority concerns of old are no longer cardinal,[11] it

---

[8] Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675 (2003) [hereinafter Baird & Rasmussen, *Twilight*].

[9] Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 932–33 (2001); David A. Skeel, Jr., *The Past, Present and Future of Debtor–in–Possession Financing*, 25 CARDOZO L. REV. 1905 (2004) (tracing the historical growth of powerful DIP lenders to the days of railroad receiverships) [hereinafter Skeel, *Past, Present and Future*].

[10] *See* Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420 (2004) (reporting data that railroads that reorganized under a receivership subsequently failed at a rate more than twice as high as railroads that had never gone through a receivership and almost three times as high as modern chapter 11 debtors) [hereinafter Lubben, *Railroad Receiverships*]. Baird and Rasmussen argue that the distinction between the modern control rights regime and the railroads of the past turns on the fact that "[c]apital structures today are better designed." Baird & Rasmussen, *Twilight*, *supra* note 8, at 696.

[11] Key examples of this older literature include Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997); Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527

is not clear that this development promotes social welfare. Rather, lender control may only benefit lenders.

I next consider whether the empirical story told by these authors is plausible. Again in contrast to the leading scholars, I argue that control in a large modern firm is often inherently ambiguous and that control rights are always relative and state–dependent. I further argue that this ambiguity counsels for a collective solution like chapter 11. In short, I argue that the spread of the "new" chapter 11 is not clearly for the best, but the extent of that spread is likely overstated.

I tackle these arguments in the remaining four parts of this paper. Part I establishes the basic framework of control rights. It describes the concept of control rights and how leading chapter 11 theorists believe that the development of strong control rights has reformed the chapter 11 process. According to these authors, improved contracting has allowed parties to distribute control rights through sophisticated contracts. In the presence of these contracts, chapter 11 assumes the vestigial role of facilitating the wishes of the party with control. Thus, chapter 11 is no longer a negotiated process among classes of creditors.

Part II looks at the implications of this conception of chapter 11. Here I probe the new chapter 11 along two fronts, examining both the normative implications of a chapter 11 that bends to a controlling creditor's will and the practical question of whether the "control rights" conception of chapter 11 leaves it with any justifiable role. In particular, if control rights are now allocated as described by these authors, what does chapter 11 offer that could not be achieved outside bankruptcy? And, more to the point, are there any benefits to filing chapter 11 that do not involve wealth transfers to the controlling creditor and other well–connected parties?

Similarly, even assuming that the control rights revolution in chapter 11 is true as a descriptive matter, as I assume in this part of the paper, it does not follow that this development is normatively sound. Without revisiting the seemingly endless debates about the broader normative purpose of business bankruptcy that a prior generation of scholars has already worked through many times, it bears considering whether placing senior lenders in charge of chapter 11 is really a good thing. In particular, the control rights version of chapter 11 is undeniably a good thing if we agree that the "things" that chapter 11 should maximize are the interests of senior lenders. The normative desirability of the control rights model

---

(1983). Recent reviews of this literature include Susan Block–Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, and Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, 270 (2001) (criticizing prior "efficiency–based conception[s] of corporate reorganization" as "doomed . . . from their inception") [hereinafter Lubben, *Realism*].

becomes more suspect if we instead believe, as most scholars probably do, that the one clear and desirable goal of chapter 11 is to maximize the value of the bankrupt firm.[12] Improving the position of senior lenders does not necessarily advance this goal.

In Part II I ultimately conclude that, if the control rights description of the new chapter 11 is accurate, chapter 11 will only be used when it benefits the controlling creditor, and we should expect these sorts of creditors to capture most or all of these benefits. Moreover, we should expect that in some cases the use of chapter 11 under a control rights regime will not be efficient; any gains come with corresponding losses to non–consenting parties.[13] Even though controlling creditors could potentially improve the chapter 11 process by obtaining a position that prevents debtors from overreaching in chapter 11, they are equally likely to use this position to collude with the debtor and its senior management to share gains that would have otherwise gone to junior creditors.

I also argue that the control rights theorists have tended to gloss over the differences between maximizing the controlling creditors' interests and maximizing the value of the bankrupt firm.[14] Thus, the normative justifications for the control rights reinterpretation of chapter 11 are woefully underdeveloped. At best, the efforts at providing a normative justification for the new chapter 11 appear to be little more than an argument that the presumed ends justify the means.

In short, the growth of a control rights model of chapter 11 reduces transparency and leaves the utility of reorganization unsettled. All cases under the control rights model will feature controlling lenders who capture most of the debtor's value. In some cases the debtor's value will have actually increased as a result of chapter 11; in others the debtor's value will simply be shifted among the parties. The unknown (perhaps unknowable) empirical issue is which of the two cases dominates. Without answering that question, the benefits of the new face of chapter 11 are, at best, unclear. Similarly unclear are the normative justifications for allowing senior lenders to maximize their interests, apparently even if those interests

---

[12] *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 22–27 (1986).

[13] As used throughout this paper, references to "efficiency" are intended to invoke a kind of modified Kaldor–Hicks efficiency that assumes that extreme distributional unfairness will not be tolerated, but that every system involves some degree of sorting between "winners" and "losers." The concept is undeniably imprecise, but similar tools have been recognized by others as a useful basis for discussion. *See, e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 18 n.32 (2004).

[14] Others have also noted the tendency to conflate senior creditors with creditors in general. *See, e.g.*, Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 860 (2004).

conflict with the broader goal of maximizing the value of the estate. Arguably the new face of chapter 11 moves business bankruptcy further away from its core goal of decreasing the overall costs of business failure.

Part III then asks if any real firm can actually point to a specific investor with absolute control over its assets? And can investors know when a particular state of the world holds, so that control might transfer to the optimal party? Because the answer to both questions must be "no," I argue that the contention that control rights can lead to the end of corporate bankruptcy as we know it is unfounded, even wrong.

Control is never coherently allocated in most real firms. Instead, creditors bargain with a firm—or, more precisely, its management—for degrees of leverage in the negotiations that will follow the firm's future collapse, if that collapse ever comes. The allocation of control rights at the point of financial distress will thus reflect the end–point of an ongoing, dynamic process.

At any point in time, even when the firm must decide whether or not to liquidate, myriad parties will possess some ability to force the firm to follow a particular course of action, though none will have the ability to make an effective decision alone. Control rights are made up of formal, or legal, and informal, or functional, components, and no one party is likely to have a monopoly on all aspects of control. Moreover, whether a firm should continue or fold is itself a question that, without the benefit of hindsight, is fraught with doubt and ambiguity. Ambiguity with respect to the ultimate form of control—control over the liquidation decision—confirms the need for a collective process like chapter 11.

The idea of ambiguous control rights goes beyond the difficulty of identifying a firm's residual owner—which, as many authors have already noted, is inordinately difficult at best—and instead shows that large firms never allocate control or decision rights to a single, residual claimant. Parties throughout the firm's capital structure may be given the right to control a firm's destiny. At most, the allocation of these control rights represents nothing more than stakes on degrees of control, the ultimate value of which is both highly relative and state–dependent. Formal control may have little relation to actual functional control.[15] In this context, chapter 11 provides a forum for an organized resolution of these competing claims.

[15] The recent strike threats by unions at bankrupt airlines is an example of this idea in action. Employees have very little formal control in comparison to lenders, but their functional control can be tremendous. *See* Keith L. Alexander, *Attendant Union Approves Strike over Contracts*, WASH. POST, Nov. 17, 2004, at E3 ("The president of the nation's largest flight attendants union yesterday vowed that its members would go on a nationwide strike if US Airways and United Airlines are allowed to nullify their labor contracts in bankruptcy court.").

Part IV then closes with a brief consideration of why we should not be too surprised that the "new chapter 11" devised by leading theorists leaves chapter 11 without any real or unique function whatsoever. For years these theorists have bemoaned the mandatory, non–market tilt of chapter 11. Underlying many of these complaints was an unstated assumption that more frequent liquidation or sale of firms—leaving any reorganization to new owners—would be both desirable and efficient. Having found that some chapter 11 debtors have adopted something close to this approach in practice, some scholars have rushed to embrace this trend as the new face of chapter 11. As I argue in conclusion, whether or not the rise of control rights is indeed a new trend in corporate reorganization, or simply a preexisting subcurrent that academics have stumbled upon, it is hardly a phenomenon that should be embraced without hesitation.

I. THE CONCEPTION OF CONTROL RIGHTS

Control rights (e.g., voting rights, liquidation rights, board membership) have been well ventilated in the finance literature for more than a decade.[16] This literature has explored the key qualitative features of corporate securities, explaining why securities have different rights at different times in a firm's life. To oversimplify, the literature has coalesced around the idea that control rights are allocated to certain parties, often contingent on some observable signal, to bridge gaps in incomplete contracts.[17]

This literature has implications for all bankruptcies, chapter 11 in particular. Accordingly, by the middle 1990s several finance articles had discussed how the efficient allocation of control rights during times of distress could be effectuated through bankruptcy systems.[18] It is this literature that several legal scholars have drawn upon to support their claims about the transformation of chapter 11. According to the "hard" form of the legal "control rights" argument, "[m]odern firms may have

[16] For a very readable summary of the literature, see Oliver Hart, *Financial Contracting*, 39 J. ECON. LIT. 1079 (2001), *available at* http://www.law.harvard.edu/programs/olin_center/papers/327hart.php. For some recent applications, see Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003); JUKKA VAUHKONEN, FINANCIAL CONTRACTS AND CONTINGENT CONTROL RIGHTS, BANK OF FINLAND DISCUSSION PAPER NO. 14/2003, *available at* http://ssrn.com/abstract=438501.

[17] *See generally* OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE (1995).

[18] *See, e.g.*, Phillippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992); Elazar Berkovitch & Ronen Israel, *The Design of Internal Control and Capital Structure*, 9 REV. FIN. STUD. 209 (1996); Julian R. Franks & Kjell G. Nyborg, *Control Rights, Debt Structure, and the Loss of Private Benefits: The Case of the U.K. Insolvency Code*, 9 REV. FIN. STUD. 1165 (1996).

complicated and dynamic divisions of control rights. These rights are nevertheless coherent in the sense that they represent a bargained agreement among investors about who should exercise control over the firm's assets in any particular state of the world."[19]

The development of new contracting techniques is said to allocate firms' control rights in a manner that permits investors to liquidate unviable firms, obviating the need for traditional chapter 11 reorganization in almost all cases.[20]

Thus, chapter 11 continues to be used only "because, as a legal matter, it provides a cheaper mechanism for assuring the buyer clean title than state law."[21] Chapter 11 will also be used "not because there is a collective action problem but because it is the easiest way for . . . [senior creditors] to extinguish junior stakeholders."[22] Chapter 11 thus becomes a process of honoring the controlling creditors' wishes with regard to the debtor's assets and allocating proceeds among competing claimants.[23]

As Baird and Rasmussen, the leading proponents of the hard form of the control rights theory, summarize:

> In the case of a large firm in bankruptcy, we find that, at the moment Chapter 11 is filed, a revolving credit facility is already in place that entrusts decisionmaking authority to a single entity. This entity will often step in and replace management. It will make the necessary operational decisions before Chapter 11 begins.[24]

David Skeel has argued for a somewhat more modest version of the control rights theory, asserting that the growth of strong post–petition lenders (a.k.a. DIP lenders) is a key factor in the improvement of chapter

---

[19] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805. Baird and Rasmussen later explained that "[t]o say that control rights tend to be allocated coherently is to say that those who have a voice in making this decision have both the skill and the incentive to make it correctly." Baird & Rasmussen, *Twilight*, *supra* note 8, at 695.

[20] *See* Baird & Rasmussen, *End of Bankruptcy*, *supra* note 2, at 777 ("A viable firm requires Chapter 11 only if those who control it cannot collectively make coherent decisions outside the bankruptcy forum."); Baird & Rasmussen, *Lessons*, *supra* note 2, at 1804 ("Many large modern Chapter 11 cases begin only after those in control have already decided to sell the firm's assets."); Baird & Rasmussen, *Twilight*, *supra* note 8, at 695.

[21] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805; *see also* 11. U.S.C. § 363(f) (2000) (specifying the circumstances under which a trustee can sell property unencumbered by third–party interests).

[22] Baird & Rasmussen, *Twilight*, *supra* note 8, at 696.

[23] *See, e.g.*, Baird & Rasmussen, *End of Bankruptcy*, *supra* note 2, at 785 ("[I]t is the lender, and not the Bankruptcy Code or the bankruptcy judge, that is deciding how long the managers will have to make a go of things.").

[24] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805.

11 from the dark days of its 1980s past.[25] Instead of focusing on *ex ante* lending agreements, Skeel's account of the new chapter 11 argues that post–petition lending agreements, blessed by the bankruptcy courts under § 364 of the Bankruptcy Code,[26] explain the new state of affairs.

In particular, Skeel argues that debtors are increasingly reliant on DIP lenders for their long–term survival, and this dependence gives the lenders power to exercise more oversight in the chapter 11 case.[27] He argues that DIP lenders have emerged as an alternative source of power in a bankruptcy system that imposed few limitations on managerial discretion when originally enacted in 1978.[28] DIP loans have repaired chapter 11 by giving lenders the control rights once exercised under receiverships by investment bankers, and under Chapter X of the old Bankruptcy Act by trustees and the SEC.[29]

Unlike Baird and Rasmussen, however, Skeel does not contend that this is uniformly a good thing, even though he tends to be rather optimistic about the role DIP lenders play. He suggests that a regime of DIP lender control will generally result in managerial discipline, which he analogizes to the market for corporate control outside of bankruptcy.[30] He argues that managerial discipline is further enhanced by the advent of managerial retention agreements, which lenders can use to align management's incentives with the aims of the lender.[31]

Under either conception of control, lenders (be they *ex ante* or *ex post*) play important roles in a firm's chapter 11 case. Under the Baird and Rasmussen "hard" conception of control rights, long before financial distress these lenders lock up virtually complete power to make decisions about how a firm's assets are used.[32] Skeel's "soft" conception of control

---

[25] Skeel, *Creditors' Ball*, *supra* note 2, at 921–22.

[26] 11 U.S.C. § 364 (2000). The importance of this section of the Code is described by Skeel: "The magical provision is Section 364, which authorizes the bankruptcy court to roll out the red carpet for a lender that is willing to make a new loan to the debtor." Skeel, *Creditors' Ball*, *supra* note 2, at 923.

[27] Skeel, *Creditors' Ball*, *supra* note 2, at 925 ("Lenders . . . [are] using the terms of DIP loans to shape the Chapter 11 case.").

[28] Skeel, *Past, Present and Future*, *supra* note 9, at 1916.

[29] *See id.*

[30] Skeel, *Creditors' Ball*, *supra* note 2, at 921–22.

[31] *Id.* at 943–44. Section 331 of the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 prohibits retention bonuses unless the bonus is essential to retain a person who has "a bona fide job offer from another business at the same or a greater rate of compensation." Section 331 also contains overall size limits on retention and severance payments. Plainly this provision has serious implications for Skeel's argument. *See* Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, § 331 (2005).

[32] *See* Baird & Rasmussen, *End of Bankruptcy*, *supra* note 2, at 779; Baird & Rasmussen, *Lessons*, *supra* note 2, at 1804.

is less direct: lenders have no direct power over assets, but they have the ability to discipline the debtor's management and reward them for desired behavior, thus mitigating the conflicting interests between managers and creditors that might otherwise exist.

Under this approach, control rights allow DIP lenders to direct the reorganization at the margins rather than steer the process in its entirety. But the result is largely the same: under either the hard or soft version of the control rights story, a select group of creditors now dominates the chapter 11 process, and the only disagreement is on the extent of dominion.

The implications of a reorganization system dominated by a select group of creditors is the subject of the next part of this paper.

II. THE IMPLICATIONS OF LENDER DOMINATION

There are plainly several debatable factual assertions imbedded in the control rights account of modern chapter 11 practice, particularly in its hard form, and other authors have already pointed out some of these issues in other papers.[33] But, as stated at the outset, this part of the paper operates under the assumption that the control rights story is correct—that is, chapter 11 has become dominated by either *ex ante* or *ex post* lenders, depending on which version of control rights one adopts.[34]

Before the advent of the new chapter 11, reorganization was a collective enterprise and state debtor–creditor law addressed individual creditor collection efforts.[35] Closely related to this collective conception of chapter 11 was the frequent argument that "the paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor."[36] Under the new approach, chapter 11 has

---

[33] *See, e.g.*, Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645 (2003) [hereinafter LoPucki, *Nature of the Bankrupt Firm*].

[34] The assumption is not entirely unrealistic; some version of the control rights story undoubtedly holds. *See* Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, AM. BANKR. INST. J., Sept. 22, 2003, at 12; *see also* Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290 (7th Cir. 2003), *cert. denied* 124 S. Ct. 2103 (2004).

[35] *See, e.g.*, 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, 105–06 (1984); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 492–93 (describing the problems arising under pre–chapter 11 debtor–creditor law) [hereinafter Skeel, *Brave New World*].

[36] *In re* Ionosphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989); *see also* United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) (describing the economic benefits of reorganization); Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 422–23 (1972) ("In contradistinction to a bankruptcy proceeding where liquidation of a

moved closer to the state–law model.[37] Secured creditors have replaced the collective under the new approach, and the bankruptcy court and junior creditors are reduced to a subsidiary role that is only triggered if the proceeds of the senior creditor's chosen disposition exceed its claims. Reorganization is not a good in and of itself; it is only pursued if it meets the controlling creditor's objectives.

But if a lender is vested with control rights immediately upon a firm's failure and will place that firm in chapter 11 only to sell or otherwise redeploy the firm's assets, why chapter 11? As noted, Baird and Rasmussen respond that chapter 11 should be used because it facilitates asset sales and the removal of junior claimants.[38] In short, chapter 11 offers better rules for selling a firm than state law.

Baird has previously argued, as part of the well–known Baird and Jackson team, that

> [c]hanges in substantive rules unrelated to preserving assets for the collective good of the investor group . . . run counter to the goals of bankruptcy. Such rule changes in bankruptcy can induce an individual investor to seek bankruptcy merely to gain access to rule changes that offer him benefits, regardless of whether there are any benefits—or indeed costs—to the investor group as a whole.[39]

This claim for parity between bankruptcy and non–bankruptcy law is sometimes referred to as the *Butner* rule.[40] If Baird and Rasmussen mean to argue that controlling parties will file chapter 11 cases only to take advantage of provisions like Bankruptcy Code § 363(f)—which allows assets to be sold free and clear of certain liens, in certain instances[41]—the control rights argument clearly represents a departure from the rule.

---

corporation and distribution of its assets is the goal, a Chapter X proceeding is for the purposes of rehabilitating the corporation and reorganizing it.").

[37] For a very clear discussion of the distinction between state and federal debtor–creditor law, with particular focus on the rights of secured creditors, see Westbrook, *supra* note 14, at 806–18.

[38] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1807 (using the Enron bankruptcy proceeding as an example); Baird & Rasmussen, *Twilight*, *supra* note 8, at 696 ("[Companies] use Chapter 11 not because there is a collective action problem but because it is the easiest way for them to extinguish junior stakeholders that are out of the money.").

[39] Baird & Jackson, *supra* note 35, at 101.

[40] *See* Butner v. United States, 440 U.S. 48, 55 (1979) ("Unless some federal interest requires a different result, there is no reason why such [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."); *see also* Julianna M. Thomas, Note, *Fifteen Years After* Weintraub: *Who Controls the Individual's Attorney–Client Privilege in Bankruptcy?*, 80 B.U. L. REV. 635, 654–55 (2000) (describing the operation of the *Butner* rule).

[41] *See generally* George W. Kuney, *Bankruptcy Code § 363(f): A Misinterpretation that Undermines the Chapter 11 Process*, 76 AM. BANKR. L.J. 235 (2002).

Others have already noted that the *Butner* parity rule represents an implicit choice in favor of non–bankruptcy debtor–creditor law,[42] and that doing so inherently means favoring certain parties (secured creditors) over other parties (unsecured creditors).[43] Although the proponents of the *Butner* rule have sometimes denied such an intent,[44] it seems rather plain that this choice is entirely consistent with a view of bankruptcy as nothing more than a device to overcome creditors' collective action problems.[45] If bankruptcy only addresses instances of contract failure, a preference for state law, whatever its merits, is logical because it generally governs most contract disputes.

In any event, we should certainly be suspicious of a chapter 11 case that is filed solely to provide a secured lender with an alternate forum for its foreclosure sale. While it is conceivable that bankruptcy–specific rules might advance the interests of the overall group of creditors, it is doubtful that a senior lender would choose chapter 11 for this reason.

Before pursuing this line of argument further, however, consider the implicit normative choice that the control rights proponents have already made at this point: chapter 11 properly provides a tool for achieving the senior creditors' objectives. Scholars of all stripes have generally assumed that the one core normative goal of chapter 11 is to maximize the value of the bankrupt firm.[46] Whether chapter 11 has or should have goals beyond this is, to understate it wildly, subject to much debate, but the maximization goal appears to be widely accepted.[47]

---

[42] *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 804 (1987) (describing the costs that would accompany straying from state debtor–creditor law).

[43] *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1945–46 (1994).

[44] *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 823–24 (1987).

[45] Note, however, that Baird apparently believes that solving collective action problems is no longer the primary purpose of chapter 11. *See* Baird & Rasmussen, *Twilight*, *supra* note 8, at 696.

[46] *See, e.g.*, Thomas H. Jackson, *Bankruptcy, Non–Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 864 (1982) (describing how a "non–piecemeal bankruptcy process" maximizes the value of assets); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 86 (1995) ("An efficient bankruptcy law . . . should ensure that post bankruptcy assets are put to the highest valued use."); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 344–45 (1993) [hereinafter Warren, *Bankruptcy Policymaking*].

[47] Several argue that bankruptcy is something more than just debt collection in a new forum. *See, e.g.*, Susan Block–Lieb, *supra* note 11, at 519–20 (describing additional purposes of bankruptcy law); Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031, 1038–43 (1994) (suggesting that communitarian concepts should be incorporated into bankruptcy law); Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333, 365

Although maximizing the value obtained by senior lenders might be consistent with bankruptcy's general entity maximization goals in some circumstances, instances plainly exist where the two goals would be in tension. Consider the controlling lender that utilizes its control to ensure that the debtor–firm obtains "exit financing"—that is, post–bankruptcy financing—only from the controlling lender. Here, the controlling lender obtains value, but the choice of post–bankruptcy lenders under these circumstances is unlikely to increase the debtor's value and may even decrease the firm's overall value.

Thus, the proponents of the control rights model have some obligation to explain why they have adopted an apparent shift away from chapter 11's traditional firm maximization goal. In some sense anything that increases the senior lender's recovery also benefits more junior creditors, as they are more likely to receive some recovery in the case.[48] Maybe. But it is equally plausible that senior lenders use the Bankruptcy Code to soak up value that they do not already claim. For example, if a chapter 11 case simply allows an existing lender to add a new layer of senior debt onto the firm in the form of a DIP loan, the new chapter 11 is simply a tool for facilitation of a wealth transfer.[49]

In this example, I assumed that the debtor's value is rather static; it remains the same in or out of chapter 11. But what if the debtor's value actually increases in chapter 11? Here, again, the senior lender could use the power of the Bankruptcy Code to allocate that new value to itself. At first blush, there seems to be no good reason to allow a senior lender to use

---

(1992) (describing the purely economic account of bankruptcy law as "unsuited to resolve practical conflicts among diverse and incommensurable values that pervade financial distress"); Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993 (1995); Warren, *Bankruptcy Policymaking*, *supra* note 47, at 344. The heat from those holding the other point of view is equally intense. *See, e.g.*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 590 (1998) (challenging the critics of the economic model to more clearly propose an alternative system); Robert Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 42 ("[T]he most important objection to those who would reject the economic conception . . . based on . . . general social injustice is that the[ir] argument fails in any significant way to link its predicate—the existence of injustice—to its conclusion—the rejection of what is otherwise a just bankruptcy regime."); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998).

[48] *See, e.g.*, Schwartz, *supra* note 47, at 1837–38 (arguing that creditor conflicts would be rare if the absolute priority rule were respected, since all creditors would seek to maximize the size of the estate).

[49] This of course assumes, not unrealistically, that the proceeds of the loan do not necessarily result in a dollar for dollar increase in the value of the debtor's estate. *Cf.* Stephen J. Lubben, *Beyond True Sales: Securitization and Chapter 11*, 1 N.Y.U. J.L. & BUS. 89, 101–04 (2004).

chapter 11 solely to benefit itself, especially if we reasonably assume that chapter 11 is more costly than its state-law counterpart.[50]

Similarly, any benefit that chapter 11 confers by increasing the price buyers pay for a debtor's assets may primarily advantage priority claimants that exist only because of the bankruptcy filing, such as the debtor's bankruptcy professionals,[51] and select junior creditors, such as the parties to contracts the debtor chooses to assume.[52] The benefits that ultimately trickle down to the junior creditors as a whole may be slight, even if the senior creditor never increases the size of its stake. Again, conferring windfalls on priority claimants and select junior creditors hardly seems a compelling reason for the use of chapter 11 in the presence of a reasonable state-law alternative.

In some cases, however, the increased costs of using chapter 11 will be outweighed by the increased value of the debtor's assets. Although these cases surely represent an efficient use of chapter 11, identifying them is rather difficult. Abstractly, a case where the senior lender's expected gains come directly from expected improvements in the value of the debtor's assets must be distinguished from a case where chapter 11 merely facilitates a transfer from existing claimants to the lender and other bankruptcy-specific parties. The transfer in the latter case is made possible by tools the Bankruptcy Code provides, such as the power to incur senior debt,[53] the power to reject contracts without full realization of breach damages,[54] and the power to assign contracts that would be otherwise unassignable at state law.[55]

Stated more formally, chapter 11 should only be preferred when the gains (g) from choosing the federal system, minus the unique costs (c) of using chapter 11 when compared with the state debtor-creditor system, and minus the value captured by the DIP lender (d) from loans made under

---

[50] While the direct costs of chapter 11 are modest compared to other significant corporate transactions, *see* Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANKR. L.J. 509, 542 (2000), they must inevitably exceed the costs of a state law foreclosure proceeding. One aspect of chapter 11 that represents an improvement over its railroad receivership predecessors is the degree of transparency that is mandated in chapter 11. But this transparency comes with costs, as the debtor's lawyers are called upon to attend meetings with creditors, and the accountants work to prepare the schedules of assets and liabilities. State foreclosure law mandates none of these steps.

[51] *See* Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 111-12 (1997) (describing lawyers as among the principal beneficiaries of reorganization).

[52] 11 U.S.C. § 365(b) (2000).

[53] § 364.

[54] § 365(g).

[55] § 365(f).

§ 364 and by creditors who hold bankruptcy–specific priorities (p), are greater than or equal to zero:

$$g - c - d - p \geq 0$$

These are the cases where we can be sure that chapter 11 represents something more than a wealth transfer, for the simple reason that the chapter 11 specific claims do not exceed the unique gains of using chapter 11. But the Bankruptcy Court cannot be expected to determine *ex ante* what g will total with any degree of reasonable precision. Only the debtor's management—if they are able to overcome the kinds of biases that often cloud managerial decisions in times of financial distress—and the senior lender are likely to have access to information that could lead to adequate predictions of these values.

Furthermore, since the size of d is subject to manipulation by the senior lender, especially with the cooperation of the debtor's management, it is doubtful that we should ever expect the net gains of chapter 11 under a control rights regime to be greater than zero. Indeed, it is likely the result of the equation will always equal zero.

Unless the senior lender underestimates g or the lender is benevolent, something lenders are rarely accused of, choosing chapter 11 over state foreclosure only benefits the senior lender—and debtor's management and other "insiders," to the extent the lender must enlist their aid—because a rational senior lender will absorb any unclaimed value that might otherwise go to the junior creditors. Further, it seems unrealistic to assume that controlling lenders would often significantly err in their valuation of the debtor. If any party could value the debtor *ex ante*, we would expect that a senior lender, entitled to detailed and frequent reports from the debtor, would be in the best position to do so.

For a concrete example, assume a debtor firm has $300 in secured claims; $200 in unsecured bondholder, trade, and tort claims; and 100 shares of equity. The liquidation value of the firm is $250, but the firm can be sold in chapter 11 for $350 (leave the reason for the increase in value vague). If the controlling creditor, the secured lender, can reasonably anticipate these values, it will gladly agree to provide the debtor with up to $50 in DIP financing.[56] Under § 364, this financing will be given priority over the unsecured claims, and the lender will take all of the firm's value. Thus, even in a case where there is a real increase in the value of the

[56] I assume that the DIP lender has no desire to engage in a "priming fight" to subordinate other secured lenders. *Cf.* § 364(d).

debtor's assets as a result of using chapter 11, the proceeding will only benefit the controlling lender.

Perhaps it is unrealistic to assume that a secured lender would ever give a DIP loan for the debtor's full value. But the lender does not need to lend the full $50. The lender only needs to lend $50 less the value of the claims held by creditors with bankruptcy–specific priorities (p), since leaving some portion of the debtor's value unencumbered in favor of these parties will facilitate the lender's exercise of control.

It is at this point that we can put a new gloss on Skeel's argument that the new chapter 11 is driven by the dual innovations of strong DIP lenders and executive retention plans, which Skeel argues align management's incentives with those of senior creditors.[57] Instead, the growth of retention agreements, along with "carve outs" for professionals,[58] could be seen as signs that the controlling creditor is dispensing portions of the debtor's value in order to ensure the lender's continued control.

But why would the junior claimants stand by while this happened? In particular, what role would the creditors committee play in this drama? First, recall that the committee's counsel is one of the professionals who may benefit from the "carve out" granted by the senior lender, and counsel always enjoys a bankruptcy–specific priority for its fees.[59] Many committee members may also hope to obtain such priority, especially if the senior lender has agreed to fund "critical vendor" payments or other preferences.[60] Finally, the junior claimants may have little choice but to agree to the senior lender's wishes; state law foreclosure would be far more painful for the junior creditors, especially since it would entail the loss of any holdup power these creditors might have in chapter 11.

The argument has thus come full circle: there are two basic types of chapter 11 cases under the control rights regime, but the two are almost indistinguishable as seen from the outside. In the first set of cases, the gains to senior creditors will come solely from wealth transfers related to the differences in rights and costs between chapter 11 and state–law foreclosure. For simplicity, call these the "bad" chapter 11 cases.

The bad cases are inefficient on two fronts: sophisticated unsecured creditors will charge all debtors an *ex ante* premium to cover their expected

---

[57] *See* Skeel, *Creditors' Ball*, *supra* note 2, at 919–20.

[58] Stated generally, a "carve out" is an agreement by the senior lender to fund some amount of bankruptcy–related professional fees from the debtor's assets, notwithstanding the lender's prior claim to those assets. *See generally* Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445 (2002).

[59] 11 U.S.C. §§ 1103, 503(b)(2), 507(a)(1).

[60] *See In re* Kmart Corp., 359 F.3d 866 (7th Cir.) (discussing critical vendor orders), *cert. denied* 125 S. Ct. 495 (2004); *see also* Lubben, *Railroad Receiverships*, *supra* note 10, at 1448–49 & n.142.

losses resulting from manipulation of the bankruptcy system, while involuntary creditors and smaller, less sophisticated creditors will suffer losses in the form of direct wealth transfers that they will never recoup because they are unable to extract *ex ante* premiums. In either instance, the overall societal costs of financial distress have increased.

The second set of cases, on the other hand, will involve real increases in the value of the debtor's assets, even after taking into account the foregoing wealth transfers. Consider, for example, the possibility that in some cases chapter 11 better facilitates negotiations among creditors and eliminates the deadweight costs of holdouts compared with state-law proceedings.[61] The controlling lenders will likely capture this increased value through a DIP loan. Yet, at least from the perspective of societal efficiency, these cases should be encouraged. Call these the "good" chapter 11 cases.[62]

The empirical assumptions one makes about the division of the universe between good and bad cases will undoubtedly influence one's acceptance or rejection of the control rights model. Even if we assume that the world is equally divided among the good and bad chapter 11 cases, however, the task facing the bankruptcy judge is considerable. In any case the court will be presented with a controlling lender who, along with a few priority claimants, will receive almost all of the value of the debtor's assets. Some cases are the good cases and should be allowed to go forward, whereas others, the bad cases, should be dismissed and returned to the state debtor–creditor system.

The judge, informed by experience, will exercise discretion in removing the cases at the margins on either extreme. Although there is good evidence that bankruptcy judges do a better job with this task than previously acknowledged,[63] it should be expected that a sizable core of

---

[61] This might be especially likely in cases involving public debt. *See* Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040, 1055–56 (2002); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 236–38 (1987).

[62] To be sure, for many readers the appellation "good" will only hold up if we glide past any debates about equity among creditors. The worst of these issues could be solved by adopting a superpriority for involuntary creditors. *See* Rasmussen & Skeel, *supra* note 47, at 86–87 (proposing priority for tort claimants). Better yet, although even more unlikely to be adopted, are the various proposals to end or pare limited liability with regard to torts. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1932 (1991); *cf.* Timothy P. Glynn, *Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329 (2004) (proposing that tort liability be extended to a corporation's "highest-ranking officers" rather than to its shareholders).

[63] *Cf.* Edward R. Morrison, Bankruptcy Decision-Making: An Empirical Study of Small-Business Bankruptcies (Oct. 7, 2003), *available at* http://www.ssrn.com/abstract=461031 (examining how well judges make shut-down decisions).

indeterminate cases remain, with some number of bad cases lurking among the good ones. Thus, there are legitimate reasons to be ambivalent about the new state of chapter 11.

This is a point where the shift in normative goals also comes back into the mix. If one hews to the traditional goal that chapter 11 should maximize overall firm value, the foregoing analysis suggests that often chapter 11 will offer no net benefit over state law. This is especially so if we reasonably extrapolate from the general goal of maximizing debtor value a secondary goal: not enriching senior creditors at the expense of junior creditors. But if the move to a new normative goal of maximizing senior creditor wealth can be justified, the descriptive view of chapter 11 I have just presented is interesting but ultimately unimportant. Indeed, chapter 11 under this rule might be a positive development when compared to state debtor–creditor law.

If the picture is so murky, why then have so many leading scholars trumpeted this new state of affairs? In part this can be explained by unannounced empirical assumptions; many of the proponents of the control rights model probably assume that most chapter 11 cases are good ones, which avoids the need to address many of the questions I have posed. But something more is at work here, and I briefly look at this issue in the final section of the paper. First, however, I turn to consider the plausibility of the control rights story itself, something I have accepted to this point.

III. RECONSIDERING THE CONTROL RIGHTS STORY

On some level bankruptcy scholars have been trying to contract their way out of chapter 11 almost since the day it was enacted.[64] The recurrent problem has been finding a party whose self interests will advance the collective good of the firm. By asserting that modern know–how has fixed the problem, the control rights proponents are able to sidestep this morass and proclaim the obsolescence of the old chapter 11.[65]

Determining which creditor is at the bottom of the heap at any given time is a difficult exercise that does not lend itself to *ex ante* contracting, as asset values may change daily and the nature and extent of a firm's

[64] For a summary of this prior scholarship, see *supra* note 11.

[65] *See* Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805 ("[I]n the case of many modern, new–economy firms, the enterprise is designed so that the firm enters bankruptcy only after all the economic opportunities associated with the assets have been exhausted."); *see also* Baird & Rasmussen, *End of Bankruptcy*, *supra* note 2, at 780 ("[W]e have learned a lot in the last century. Investors are now better able to anticipate financial distress. When writing investment contracts, they know not to allow managers unfettered control when things go poorly. By the same account, junior investors know that senior creditors should not be able to act opportunistically when the firm is worth keeping intact.").

liabilities change with every purchase order issued or invoice paid.[66] Moreover, any current residual claimant is likely to have the appropriate incentives to maximize firm value only so long as they remain the residual claimant, leaving the firm in the hands of an inappropriate party once a new claimant assumes the residual position.[67]

But the quest for a residual claimant is itself misguided. Even assuming such a claimant could be identified—and I tend to agree with those who think it unlikely—a residual claimant would never have the kind of complete control over a firm's fate that is necessary for the control rights contentions to hold. A residual claimant would be residual in the sense of having the right to whatever value is left in the firm after senior claimants are paid; no residual claimant, even a sole equity owner, has complete power over the use of a firm's assets, unless we make the dubious assumption that the firm is categorically debt free.[68] In short, finding a residual claimant is irrelevant to the larger issue of identifying a party or group with control rights.

To clarify this argument, it will be helpful to define "control" with more precision, and with a more functional meaning than I have used thus far. This requires consideration of control along two dimensions: formal control rather than actual control, and control at the margins rather than control across a range of details. In the first instance we are dealing with control as contemplated under state corporate law, for example, juxtaposed with functional control from a business perspective. In the second instance we are dealing with control or power to make a firm's continuation or investment decisions, juxtaposed with the power to make its more routine operational decisions.[69]

Parties may possess various forms of control, depending on the facts at hand, and a party's apparent control may have little relationship with functional reality. In times of financial distress a secured lender is vested with a good deal of formal control, though secured lenders rarely exercise

---

[66] *See* Lubben, *Realism*, *supra* note 11, at 279.

[67] *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 771–76 (1993).

[68] As I argued in an earlier article, any attempt to operate a firm with an equity–only capital structure would be both impractical and costly, as management would be compelled either to retain a large portion of the firm's assets as cash or adopt a conglomerate structure to internalize funding needs. Lubben, *Realism*, *supra* note 11, at 286.

[69] Baird and Rasmussen assume that formal control perfectly tracks actual control and are often unclear about whether their conception of control rights includes marginal or operational control. Skeel, on the other hand, more clearly states that his controlling lenders exercise non–operational, coercive control over the debtor.

these formal legal rights.[70] A secured lender's actual control in times of distress comes from its ability to control the debtor's future access to cash, rather than its rights in the debtor's assets.[71]

Trade creditors have little formal control in times of financial distress. They are typically unsecured, often highly reliant on a debtor's ongoing business, and thus generally unwilling to press for the prompt payment of invoices even as chapter 11 looms near. But if the debtor hopes to reorganize and continue as a going concern, the trade creditor may have a good deal of informal, marginal control, especially if the transaction in question involves significant asset specificity.[72] For example, the railroad that is owed money for past shipments is formally indistinguishable from any other unsecured creditor. But if the debtor's plant relies on regular deliveries of raw materials, especially if the deliveries are too bulky to come by other means, the railroad has the ability to shut down the plant by refusing future shipments. This exemplifies an unsecured creditor's informal ability, at the margins, to force a liquidation.

In bankruptcy, each claimant's short-term actual and marginal control are limited by the imposition of the automatic stay,[73] but no single party has the ability to impose a sale or reorganization on the firm and the other claimants in all circumstances. A secured lender can threaten to quit supplying cash if the debtor does not sell the firm within a certain time, but the key suppliers can retort that a quick sale would destroy the prospect of future trade with the debtor, thus making the debtor's past unpaid invoices less forgivable. Would not the secured lender prefer to ensure that the debtor is still a going concern when the sale closes?[74]

Moreover, it bears noting at this point that the contention that a coherent allocation of control rights determines "who should exercise control over the firm's assets in any particular state of the world"[75] relies on the assumption that these states of the world are observable either

---

[70] *See generally* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159 (1997).

[71] *See* Westbrook, *supra* note 14, at 816–17.

[72] *Cf.* Oliver E. Williamson, *Transaction Cost Economics*, *in* 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 143 (Richard Schmalensee & Robert D. Willig eds., 1989) ("[A]sset specificity not only elicits complex *ex ante* incentive responses, but, even more important, it gives rise to complex *ex post* governance structure.").

[73] *See* 11. U.S.C. § 362 (2000).

[74] For example, if the debtor owes the supplier $100 on unpaid pre-bankruptcy invoices, but the supplier expects to make future sales with a present value of $150, continuing the relationship with the debtor makes sense because the supplier stands to make a net gain of $50 even if it receives nothing on the unpaid invoices. If the supplier cannot expect to make future sales with a present value of at least $100, there is no reason to continue to trade with the debtor.

[75] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805.

directly or by way of a reliable signal. In particular, although they never address it, Baird and Rasmussen plainly presume a dichotomous world—a world where success and failure are clearly identifiable and are the only possible results for a firm. This assumption is behind much of the appeal of their argument. It is easy to decide what to do when firms clearly succeed or fail, so why should a court do what the parties could do by contract? But their assumption fails to account for a more realistic world in which success or failure is a function of which yardstick the firm is measured against. In this more realistic world, continuation is a function of the following matrix:

Continuation is . . .	*Suboptimal*	*Optimal*
Profitable	(positive NPV but better projects exist)	(turnaround is possible)
Unprofitable	(delaying the inevitable)	n/a

Distinguishing among these states of the world and accurately describing that distinction in an *ex ante* contract,[76] particularly with regard to those states in the top row, is highly problematic and further weakens the picture of coherency that Baird and Rasmussen need for their arguments to hold. If the parties are unable to determine which state of the world they are in, how can they agree *ex ante* "who should exercise control over the firm's assets in any particular state of the world"?[77]

In sum, no claimant has control rights to the full extent Baird and Rasmussen suggest. This is in large part because the congruence they assume between legal and actual control is unfounded, and the crisp states of the world they rely on are belied by a more opaque reality. Moreover, it is unclear that senior lenders would ever seek full control in a world where they must act in the shadow of potential lender liability.[78] Lender liability

[76] The state of the world reflected by the lower, right corner of the table reflects a situation where continued operation of the firm might be unprofitable, yet some party benefits from continuation, such as a controlling shareholder or a non–claimant constituency. I assume that such benefits are not recognized reasons for continuing to operate a money–losing firm, but real world examples do exist (e.g., Amtrak).

[77] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805.

[78] *See, e.g.*, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (finding lender liable to borrower after lender cut off financing to borrower); A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981) (holding creditor liable for debtor's breach of contract to third–parties under theory that lending created agency relationship

effectively transforms the lending relationship from one where returns are normally distributed to one where the downside risks are, at least theoretically, unlimited—an undeniably strong incentive to avoid complete control.

But are my hypothetical debtors typical? Might Baird and Rasmussen have a different type of firm in mind when they argue that modern firms reflect a sensible, agreed upon allocation of control rights? Maybe, but the two examples they offer, TWA and Webvan, hardly illustrate their argument any better. In their *Lessons from Enron* article,[79] Baird and Rasmussen point to TWA in support of their claim that

> large modern Chapter 11 cases begin only after those in control have already decided to sell the firm's assets. Shortly after bankruptcy is filed, the bankruptcy judge oversees the sale of the firm's assets and ensures that the assets may be transferred free of the contention among those who have competing claims.[80]

TWA did indeed sell itself to American Airlines shortly after filing for chapter 11 protection. But who exercised the control rights at TWA and decided on the sale? American provided post–petition funding for TWA during the bankruptcy, but since it clearly was not a "senior lender" before it committed to the acquisition, it could not be the control party Baird and Rasmussen would identify as having the final say over the firm's assets.[81]

Indeed, there is no clear control party at work in the TWA case. At best, management could be identified as having the "control rights" to decide the firm's fate. Yet Baird and Rasmussen are not concerned with control rights qua control rights, but rather with control rights that compel an efficient allocation of assets. Vesting non–owner management with control rights hardly seems to meet this test.

Webvan is no more illustrative of the coherent allocation of control rights. In *Lessons from Enron*, Baird and Rasmussen refer to Webvan to support the contention that "in the case of many modern, new–economy firms, the enterprise is designed so that the firm enters bankruptcy only after all the economic opportunities associated with the assets have been exhausted."[82] In a subsequent article in the *Stanford Law Review*, they take the point further, arguing that "[f]rom beginning to end, control of

---

between creditor and debtor).

[79] Baird & Rasmussen, *Lessons*, *supra* note 2.

[80] *Id.* at 1804.

[81] *See id.* Baird & Rasmussen do not explain why TWA is more typical than USAir or United Airlines, both of which are pursuing more traditional reorganization cases. Similarly, Webvan is said to be typical, and, by implication, other retailers like Kmart are not. Why?

[82] *Id.* at 1805.

Webvan's assets rested with those in the best position to make the strategic decisions."[83]

Webvan appears to be a better illustration of managerial free agency—refrains of Berle and Means[84]—than of the coherent allocation of control rights. It also provides a possible example of the difficulties that controlling parties have in distinguishing among states of the world when making the continuation decision.

Webvan only called it a day when it had run through its once–prodigious hoard of cash, by which point it was able to repay its unsecured debts at less than half of their face value.[85] Why this result was any more efficient than liquidation at any other point in time, perhaps when creditors could have received something close to face value for their claims, is left entirely unexplained.

If control rights are generally not coherently allocated in modern firms, but are instead subject to a large degree of vagueness, Baird and Rasmussen's companion assertion that the allocation of control rights within a firm represents a bargained–for agreement seems equally suspect. Plainly, any sort of actual bargaining among the myriad claimants that interact with a large firm is unrealistic given the transaction costs involved—that is why corporate entities exist.[86] I take it that Baird and Rasmussen instead argue that the allocation of control rights represents a kind of consent to one's place within a firm's financial structure.

Not unexpectedly, this precludes any participation by involuntary creditors in the allocation of control rights.[87] Moreover, the idea of tacit consent to the allocation of control is implausible in light of the foregoing discussion. Can it be that Webvan's creditors really bargained for (i.e. consented to) management's decision to operate the firm until it could not be operated any more?

Although I have focused on the hard form of the control rights argument advanced by Baird and Rasmussen, David Skeel's more modest post–bankruptcy control rights story is equally problematic. Whether pre–

---

[83] Baird & Rasmussen, *End of Bankruptcy*, *supra* note 2, at 781.

[84] *See generally* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[85] LoPucki, *Nature of the Bankrupt Firm*, *supra* note 33, at 664.

[86] *See generally* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

[87] *See* Lubben, *Realism*, *supra* note 11, at 281–82 (noting a similar flaw in Alan Schwartz's *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998)). Many others have noted the frequent exclusion of involuntary creditors from theoretical models of bankruptcy. *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 884 (1996); LoPucki, *The Unsecured Creditor's Bargain*, *supra* note 43, at 1900; Elizabeth Warren, *The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1383 & n.27 (1997).

or post–bankruptcy, in a normal, large American firm no creditor has "control rights" in the absolute sense that any of these theorists envision. Instead, creditors bargain with the firm—or, more precisely, its management—for degrees of leverage in the negotiations that will follow the firm's future collapse, if that collapse ever occurs. These negotiations take place through time, resulting in an ever–changing allocation of control relative to the financial condition of the firm and the degrees of control that the firm's managers have already sold to other claimants. Though a post–bankruptcy lender obviously contracts after much information has been revealed and is thus in a much better bargaining position, even this lender's control rights are limited by the powers other parties retain, including powers given to these parties by the Bankruptcy Code.[88]

Control rights are thus relative and state–dependent, and the amount of effort that claimants will expend on obtaining these rights will turn on each claimant's perception of the debtor's financial condition. For example, if a pre–bankruptcy creditor that is about to lend a potential debtor $100 currently believes

a) that it will cost $5 to improve the creditor's position in bankruptcy,
b) that the creditor will recover 50% of its claim in bankruptcy without such protection, and
c) that the potential debtor has a 5% chance of actually filing for bankruptcy,

the creditor's decision is between $5 in costs now or the present value of $2.50 in expected bankruptcy losses.[89] This creditor will not negotiate for more protection.

A subsequent creditor facing the same choice when the risks of bankruptcy are higher or lower, or a creditor with different beliefs about its likely recovery in bankruptcy, will come to a different conclusion. A creditor's beliefs about its potential recovery in bankruptcy are, in turn, driven by what protections other creditors have decided to negotiate for; the more secured and securitized the creditors, the less potential for recovery by unsecured creditors and the greater the value of obtaining an *ex ante* position improvement.

Even when a claimant may formally obtain a superior position with respect to the allocation of proceeds upon liquidation, that position will not represent "a bargained agreement among investors about who should exercise control over the firm's assets in any particular state of the

[88] The power to investigate the lender's pre–bankruptcy relationship with the debtor is one such power. *See* 11 U.S.C. § 1104(c) (2000) (court must appoint an examiner upon request if debtor's "unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.").

[89] The creditor's unpaid claim of $50, discounted by the expected chance of actually incurring this loss (5%).

world."[90] Instead, that claimant's superior position simply reflects its superior leverage relative to the other claimants. Nevertheless, each significant junior claimant still maintains its leverage to influence the deployment of the debtor's assets by vetoing decisions at the margin; there is no single "control party" in the sense necessary for control rights arguments to hold.

The allocation of control rights at the point of financial distress will thus reflect the end–point of an ongoing, dynamic process. In a firm with multiple claimants, no one claimant is likely to achieve absolute power to decide whether or not to liquidate the firm. Instead, claimants will have varying degrees of leverage which will determine whether or not they have the power to influence management's choice of a particular course of action or whether they merely have the power to constrain choices at the margin.

Often several parties will have control rights that are closely matched in terms of their degree of leverage. Consider, for example, the finance company that leased refrigeration equipment to a grocery store chain and the distributor that provided the debtor with its inventory. Although neither creditor is sufficiently important to the debtor without the other—the debtor does not need deliveries of frozen foods if it has no refrigeration cases and vice versa—both creditors have the ability to inflict unilateral harm on the debtor. This does not change even when the debtor has given formal post–bankruptcy control to a DIP lender.

Upon the onset of financial distress, the allocation of control rights between these two creditors is inherently open to contest. The finance company has the formal control provided by its lease agreement, but the value of that control may be minimal depending on the market for used freezers. Even this degree of control may vanish altogether if the supplier exercises its ability to halt future deliveries to the debtor. The automatic stay does not compel creditors to continue to trade with the debtor unless they have contractually bound themselves to do so.[91] Though this is perhaps more likely in the case of the finance company, it is an open question in the case of the supplier, and in all cases it is subject to the creditor's decision that it would rather risk the wrath of an angry judge and a suit for damages than trade with the debtor.[92] Throughout, the DIP lender's overriding

[90] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805.

[91] *See generally* Donald Wayne, Note, *Postbankruptcy Refusals to Deal with the Debtor and the Automatic Stay: A Fresh Approach*, 72 WASH. U. L.Q. 507 (1994).

[92] Because corporate debtors, unlike individuals, cannot recover punitive damages for breach of the automatic stay, *see* 11 U.S.C. § 362(h), the decision to attempt to end the relationship in this context is subject to substantially less risk. *Cf.* Spookyworld, Inc. v. Town of Berlin (*In re* Spookyworld, Inc.), 346 F.3d 1, 7–8 (1st Cir. 2003) (following other appellate courts in holding that a corporation cannot sue under § 362(h) for violations of the automatic stay).

formal control plays a very small role in the debtor's negotiations with these key creditors.

In short, control rights are not only relative but also uncertain or ambiguous. In normal firms, claimants do not come pre-labeled as the parties "who should exercise control over the firm's assets,"[93] and often it will be impossible to make any such determination. Even when it is possible to determine that one creditor stands above the others because it has formal control—a secured lender, for example—other creditors have enough actual control to prevent unilateral action. In the end, these two aspects of control, relativity and ambiguity, are fatal to the control rights theorists' claims that controlling parties have taken over, because these claims rest on the dubious notion that a single party or group has the complete power to determine the debtor's fate.

IV. THE SAME OLD STORY?

At first blush, the control rights literature seems to represent a remarkable turnaround for some of the strongest critics of chapter 11. Baird's early and abundant criticism of chapter 11 is well known,[94] Rasmussen is the author of a leading article favoring the ability to opt out of chapter 11 by contract,[95] and Skeel, although perhaps more tolerant of chapter 11 than the others,[96] has suggested that corporate bankruptcy should become part of state (as opposed to federal) corporate law.[97] Thus, it may be surprising to find this group praising bankruptcy judges and the workings of chapter 11. Has everything changed? Or has nothing changed?

First, it is clear that the control rights model of chapter 11 is in many ways compatible with the earlier calls to dramatically revamp chapter 11. These proposals called for a corporate bankruptcy model that would have replaced chapter 11's collectivism with quick market sales of the debtor

---

[93] Baird & Rasmussen, *Lessons*, *supra* note 2, at 1805.

[94] *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); Baird & Jackson, *Corporate Reorganizations*, *supra* note 35; Douglas G. Baird & Thomas H. Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. 299 (1984); Douglas G. Baird & Thomas H. Jackson, Kovacs *and Toxic Wastes in Bankruptcy*, 36 STAN. L. REV. 1199 (1984); Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175 (1983).

[95] *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992).

[96] *See, e.g.*, Skeel, *Brave New World*, *supra* note 35.

[97] *See* David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

followed by cash distributions to creditors.[98] The control rights model is built on a belief that many controlling lenders will exercise their power to force an early sale of the debtor rather than wait for the negotiation of a plan. Thus, both models eschew negotiation in favor of sales and, in some sense, the control rights conception of chapter 11 can be seen as a "second best" solution, embraced by scholars who find the chapter's collectivism misguided and inefficient.

In fact, the control rights argument is somewhat more sophisticated: it argues that developments in the finance markets have overtaken any need to replace chapter 11 with a market–driven approach. Under Skeel's view of the control rights model, DIP lenders have become increasingly sophisticated, deploying not only their loan agreements but also retention agreements to align managers with the lenders' objectives. The Baird and Rasmussen model of control rights similarly argues that the kind of choices about asset deployment that chapter 11 was designed to address are now preempted by contract.

In short, these one–time critics of chapter 11 now see a chapter 11 that is entirely different from the one they critiqued in the 1980s and early 1990s. Chapter 11 has not conformed to their original models, so their embrace is less than triumphant, but chapter 11 no longer presents the kind of gnawing intrusion into the free capital markets it once seemed to represent. Thus, to answer the question "has anything changed," there has been significant change. But, as so often is the case, the change came more from the world of practice than the academy.

The proponents of the control rights conception of chapter 11 may well respond that their earlier models are legitimized by all of this, since actual practice has demonstrated that the old chapter 11 was unacceptable to the markets. Extrapolating from this, one might even argue for modification of the current chapter 11 to further enhance and facilitate the exercise of lender control rights. Of course, this response again assumes that the normative goal of chapter 11 should be facilitation of senior lender control. But as I have argued throughout, there is no good reason to think that the control rights approach is efficient from a societal perspective; it is likely only efficient from the perspective of the controlling lender.[99]

---

[98] *See, e.g.*, Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 139 (1986). The problems that led bankruptcy courts to eschew market valuations of bankrupt firms in the first place are examined in a classic article by Walter Blum. *See* Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950).

[99] Some might also question the use of the market as the relevant criteria in the first instance, although I leave that argument for others to make.

CONCLUSION

For more than twenty–five years chapter 11's critics have been engaged in the "quixotic task of heralding Chapter 11's inadequacies to a world that does not seem to be listening."[100] Chapter 11 has withstood these attacks largely unchanged.[101]

Today many of these same critics have embraced chapter 11. In this article I have explored some of the possible implications of that embrace—implications that should leave the careful scholar (and bankruptcy judge) to wonder if the new chapter 11 should not be examined with a bit more care.

The idea of chapter 11 as a long, slow process directed by a "hands on" bankruptcy judge, in over his head, was once popular among the critics of chapter 11, no doubt driven by the arguably aberrant but admittedly pathetic tale of Eastern Airlines's glacial collapse.[102] Even if this picture of chapter 11 was once accurate, the control rights story of why it changed, based on innovations in contracting for controls rights, is unpersuasive. And if control rights are not absolute, but are instead relative and often ambiguous, claimants need a forum to resolve their competing claims and agree on a plan for redeploying the firm's assets. Chapter 11 currently provides such a forum.

---

[100] Lubben, *Realism*, *supra* note 11, at 270.

[101] *See* Kevin A. Kordana & Eric A. Posner, *A Positive Theory of Chapter 11*, 74 N.Y.U. L. REV. 161, 163 (1999) ("The current system has been in place for twenty years and, despite much dissatisfaction, has so far been resistant to reform.").

[102] *See* Lubben, *The Direct Costs of Corporate Reorganization*, *supra* note 50, at 543 (crediting Professor Rasmussen with popularizing the story of Eastern's demise as the archetypal chapter 11 case); *see also* Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines*, 48 J. FIN. ECON. 55 (1998).