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Comment

William C. Whitford
Wisconsin Law School.

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COMMENT

WILLIAM C. WHITFORD*

Stuart Gilson, writing sometimes with Michael Vetsuypens, has produced an impressive body of empirically based scholarship documenting extensive creditor control over financially distressed firms.[1] This work should end the practice of starting an analysis with the assumption that management in financially distressed firms remains loyal to equity interests.[2]

Gilson and Vetsuypens have little doubt that creditor control of insolvent firms is a good thing. They see creditor control as a way of putting decisionmaking in the hands of the residual claimants—"those whose wealth directly rises or falls with marginal changes in firm values."[3] Placing decisions in the hands of persons whose futures will be affected by them is, in principle, a good thing. Nonetheless, I see the question of the desirability of creditor control of the insolvent firm as more complex than Gilson and Vetsuypens do.

First, many publicly traded firms will be only somewhat insolvent, not deeply so, when entering bankruptcy or undergoing other financial reorganization. In such cases creditors are the residual claimants, and yet they are not indifferent to outcomes with an equally likely prospect of gain or loss. Substantial gains will push the firm into solvency, and some of the gain will accrue to the benefit of equity interests. Yet creditors will continue to bear all future losses. Consequently, they have an incentive to cause the firm to adopt conservative investment strategies—i.e., ones that

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* Young-Bascom Professor of Business Law, Wisconsin Law School.

1. The previous articles are summarized, and then augmented, in Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms*, 72 WASH. U. L.Q. 1005 (1994).

2. *E.g.*, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1052 (1992) ("The social costs of Chapter 11 proceedings are well known. Bankruptcy law encourages corporate managers . . . to create a net equity position for stockholders . . . . [T]he Chapter 11 presumption in favor of reposing control . . . in the hands of prebankruptcy management leaves creditors with too little influence over the reorganization process to protect themselves adequately . . . .").

My frequent collaborator, Lynn LoPucki, and I have argued elsewhere that this assumption should never have been made, even on an a priori basis. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Firms*, 141 U. PA. L. REV. 669, 694-716 (1993). Like Gilson and Vetsuypens, we also have published work that disproves the assumption empirically. *Id.* at 720-52.

3. Gilson & Vetsuypens, *supra* note 1, at 1006.

avoid risks of additional losses even at the cost of forgoing more likely prospects for gain.[4] These motivations are just the inverse, of course, of the distorted incentives of equityholders in such circumstances; equityholders have everything to gain and nothing to lose, and thus, are likely to urge investment strategies that are too risky.[5]

A second reason that the desirability of creditor control is a complex question is that creditors are rarely a monolithic group with identical interests. In large, publicly held firms there are likely to be priority conflicts even within the unsecured creditor group. One of these creditor groups will constitute the residual claimants, as that term is used by Gilson and Vetsuypens. However, the value of the firm may be close enough to the line at which this group is no longer the residual claimants that the group is not indifferent between risk of loss and prospect of gain. Indeed, the existence of groups with different priorities among unsecured creditors increases the likelihood that in any particular case the residual claimant group will unduly prefer either avoidance of risk or prospect for gain.

Creditors differ in ways other than their formal priority entitlements. Trade and employee creditors often have an incentive to favor reorganization of the firm under current management, because of the prospect of future profits from continued relationships with the surviving firm. The prospect of future profits may induce these creditors to approve unfavorable treatment of past obligations. Institutional creditors may also hope for future business with a surviving firm, but in most instances they can withdraw from the business relationship more cheaply than the trade and employee creditors can.[6]

Institutional creditors are also more likely than trade or employee creditors to be important players in other insolvency proceedings. As repeat players, they need to be concerned about how their stance in one case may affect their returns in other cases. This concern may cause them

4. Gilson and Vetsuypens may be anticipating this problem when they limit their endorsement of creditor control to circumstances "[w]hen a firm is *clearly* insolvent, and the face value of outstanding debt *far* exceeds the present discounted value of the assets." Gilson & Vetsuypens, *supra* note 1, at 1006 (emphasis added). I suggest that the difficulty described in the text arises with considerable frequency, particularly when one considers the possibility of intercreditor conflicts described below.

5. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 334-37 (1976).

6. In the language sometimes used to describe this situation, institutional creditors are likely to have made fewer idiosyncratic investments in the relationship with the debtor—investments that will be lost if the debtor fails to reorganize.

to take a tough stand in a particular bankruptcy in the hope that this action may result in a favorable precedent, or create a reputation for obstinate bargaining, that will yield positive returns in other cases. Such action can be sensible even if the resources invested in pursuing a negotiating or litigating position in one case exceed the potential return in that case. Such action would rarely be maximizing for trade or employee creditors.[7]

Although there is now a considerable body of empirical evidence about the reorganization of insolvent firms, no studies have concentrated on the intercreditor conflicts mentioned in this Comment. It is hoped that the next generation of studies will make such conflicts an important focus. We need to know more, for example, about how intercreditor conflicts are resolved within creditor committees. I would not be surprised if the interests of institutional creditors are identified as the general creditor interest, even when other creditors have quite different interests.

The presence of intercreditor conflicts raises questions about the desirability of creditor control of insolvent firms. Unless some mechanism can be devised to insure that the interests of all types are represented, it may be better to leave management in control and give them appropriate incentives to maximize the interests of the firm, rather than the interests of any one group of claimants of the firm. Lynn LoPucki and I have written extensively about this problem.[8] I will not repeat our proposals here.

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7. The interests of occasional creditors, such as tort claimants, are different still. Because they are likely to be creditors only in one case, they have less incentive to adopt a litigious stance in a particular case, since they can justify that stance only if it will yield a positive return in the particular case. On the other hand, the occasional creditor cannot look to profits from future transactions from the debtor, and hence, does not have the same incentives as trade and employee creditors to avoid liquidating solutions to insolvency.

8. Lynn M. LoPucki & William C. Whitford, *Compensating Unsecured Creditors for Extraordinary Bankruptcy Reorganization Risks*, 72 WASH. U. L.Q. 1133 (1994); LoPucki & Whitford, *supra* note 2, at 787-96.