Washington University Law Review

Volume 72
Issue 3 *Interdisciplinary Conference on Bankruptcy and Insolvency Theory*

January 1994

Improving Bankruptcy Procedure

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IMPROVING BANKRUPTCY PROCEDURE

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I. INTRODUCTION

There is a widespread dissatisfaction with bankruptcy procedures throughout the world. Bankruptcy reform is being actively considered in the United Kingdom and France and is in the air in the United States. East European countries that must select a bankruptcy law for their new capitalistic economies have had a hard time making the choice and in some cases, dissatisfied with their original decisions, are already making changes.[1] Russia has recently implemented a bankruptcy law that seems complex and apparently suffers from many of the disadvantages of Western procedures.[2]

We believe the reason for this unsettled state of affairs is that bankruptcy law has developed in a fairly haphazard manner, as a series of attempts to solve perceived immediate problems. There has been relatively little effort to step back and ask what the goals of bankruptcy procedure should be, or to consider how one would set up an optimal bankruptcy procedure if one were starting from scratch. To put it another way, economic analysis—which has been applied with such great success to other aspects of law in the last thirty years—has, with a few notable exceptions, not been used to shed light on optimal bankruptcy procedure.[3]

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* Nuffield College, Oxford; Harvard University; and London School of Economics and University of Edinburgh, respectively. We would like to thank Rabindran Abraham, Barry Adler, Donald Franklin, Lynn LoPucki, Paul Sheard, Andrei Shleifer, and Geoff Stewart for helpful comments on earlier versions of this article.

1. An example is the case of Hungary. In the original Hungarian bankruptcy law, the debtor was obliged to announce a reorganization or bankruptcy procedure after 90 days of failure to pay any of its debt. This triggered a huge wave of bankruptcies, and in mid-1993 an amendment to the bankruptcy law abolished the mandatory announcement of bankruptcy. *See* INSTITUTE FOR EAST-WEST STUDIES, ENTERPRISE BANKRUPTCY IN RUSSIA: CRITICAL RECOMMENDATIONS FOR MICROECONOMIC RESTRUCTURING (1993).

2. *See id.*

3. The notable exceptions include Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY

This Article attempts to provide an economic perspective on bankruptcy procedure. In Parts II and III, we discuss the rationale for, and goals of, bankruptcy procedure. Part IV describes how existing procedures fall short of these goals. Our main point is that reorganization procedures like Chapter 11 are flawed because they mix the decision of who should get what with the decision of what should happen to the bankrupt company. In Part V, we turn to a procedure that we have proposed elsewhere, which we believe would improve on existing procedures.[4] In our scheme, debt claims are converted into equity, and the decision about whether to reorganize or liquidate is then put to a vote. The merit of the scheme is that all claimants, once they are shareholders, have a common interest in voting for the efficient outcome. In Part VI, we discuss some practical difficulties concerning our proposal and how they might be resolved. Part VII contains concluding remarks.

II. BACKGROUND

Companies take on debt for many reasons. To mention just a few: they may wish to reduce taxes; they may wish to commit themselves to reduce slack; or they may wish to signal that future prospects are good. Whatever the reason, there will be circumstances, arising perhaps from an unexpected shock, in which the company will be unable to pay its debts. Bankruptcy law is concerned with what should happen in such situations.

The analysis of optimal bankruptcy law is complicated by the following observation. In an ideal world, debtors and creditors would anticipate the possibility of default and specify as part of their initial contracts what should happen in a default state: in particular, whether the company should be reorganized or liquidated and how its value should be divided up among the various creditors. In other words, the parties would provide their own bankruptcy procedure: there would be no need for a state-provided bankruptcy procedure.

In practice, transaction costs are likely to be too large for debtors and creditors to craft their own bankruptcy procedures, particularly in situations where debtors acquire new assets and new creditors as time passes.

LAW (1986); and Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganizations*, 83 COLUM. L. REV. 527 (1983).

4. *See* Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORGANIZATION 523 (1992). This procedure is currently under consideration in the United Kingdom. It appears as Appendix E in THE INSOLVENCY SERVICE, THE INSOLVENCY ACT 1986: COMPANY VOLUNTARY ARRANGEMENTS AND ADMINISTRATION ORDERS, A CONSULTATIVE DOCUMENT (1993).

Instead, parties may prefer to rely on a "standard form" bankruptcy procedure provided by the state. It is a long way from this observation, however, to any conclusions about the *nature* of such a standard-form procedure. The problem is that the theory of optimal contracting in the presence of transaction costs (the "theory of incomplete contracts") is in its infancy. In particular, we are aware of no formal analysis that *both* explains why it is rational for parties to leave out of their contract what should happen in a default state *and* shows how a state-provided procedure can improve matters.[5]

Thus, in what follows we do not derive an optimal bankruptcy procedure from first principles. Instead our approach is to use economic theory to guide us as to the nature of a "good" bankruptcy procedure. In the next section we suggest some goals that an efficient bankruptcy procedure should satisfy. Later (in Part V), we describe a procedure that we believe meets these goals. Although we do not claim that our procedure is optimal, we think that it is practical and avoids some of the pitfalls of existing procedures. Also, the procedure is sufficiently simple and natural that future work may show it to be optimal within a reasonable class of procedures.[6]

It is also worth pointing out that, while we propose our procedure for use by the state, it could, in principle, also be adopted by companies of their own accord. In other words, to the extent that a company can opt out of existing bankruptcy procedures, it may wish to select our procedure—as a mechanism for resolving financial distress—as part of its initial contracts with its creditors.

III. Goals of Bankruptcy Procedure

As noted, we do not proceed from first principles. However, on the basis of economic theory, we believe that the following are desirable goals for a bankruptcy procedure. As we shall see, some of these goals may conflict.

5. The fundamental importance of transaction costs has been stressed by Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), and OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985). For a recent discussion of the difficulties of analyzing the state's role in filling in the gaps of contracts, see Oliver Hart, *Is "Bounded Rationality" an Important Element of a Theory of Institutions?*, 146 J. INSTITUTIONAL & THEORETICAL ECON. 696 (1990).

6. We do not believe that our procedure should be mandatory. Anybody who wishes to deviate from it and craft their own procedure should be allowed to do so.

First (goal 1), a good bankruptcy procedure should try to achieve an ex post efficient outcome (that is, an outcome that maximizes the total value of the proceeds—measured in money terms—received by existing claimants). The efficient outcome may be to close the company down and sell off the assets for cash, to sell the company as a going concern for cash, or to reorganize the company.[7] Second (goal 2), a good bankruptcy procedure should give managers the right ex ante incentives to avoid bankruptcy. In particular, a good procedure should not favor incumbent managers, although it should not preclude them from retaining their jobs if the bankruptcy was due to bad luck rather than bad management.

Third (goal 3), a good bankruptcy procedure should preserve absolute priority. That is, the most senior creditors should be paid off before anything is given to the next most senior creditors, and so on down the ladder (with ordinary shareholders at the bottom). Finally, as a fourth goal (goal 4), a good bankruptcy procedure should, whenever possible, put ultimate decisionmaking power in the hands of the claimants rather than in the hands of the judiciary or experts.

Let us briefly discuss the rationale for goals 1-4. Goal 1 simply reflects the idea that, other things being equal, more is preferred to less; in particular, if a procedure can be modified to deliver higher total ex post value, then, given that absolute priority is preserved (i.e., goal 3), everybody will be better off. Goal 2 reflects the idea that debt may have an important role in constraining or bonding managers to act in the interest of claimholders. Managers may have taken on debt at an earlier stage as a way of committing themselves to reduce slack.[8] A bankruptcy procedure that lets managers off too lightly if they fail to pay their debts—for example, by favoring them in the reorganization process—will interfere with the ex ante bonding role of debt.

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7. Note that we exclude "external" considerations from our definition of efficiency: that is, we assume that the important benefits and costs have been incorporated into the valuation of the firm. For example, we do not include such items as the external benefit from maintaining employment in the local area. Our view is that if there are external considerations, government action may indeed be warranted, but bankruptcy law is the wrong instrument for dealing with such considerations. It would be better to have a general employment subsidy to save jobs than to distort bankruptcy procedures in order to save bad firms.

8. The use of debt as a bonding device presumably arises because other devices to keep management in check—incentive schemes, proxy fights, and takeovers—cannot always be relied upon. The stimulus for the increase in debt might have been a hostile takeover bid that management was trying to resist; or management might have been trying to raise funds from the capital market and found it necessary to issue debt in order to convince the market that it would use the funds wisely. For more on this issue, see Aghion et al., *supra* note 4.

Absolute priority (i.e., goal 3) is desirable for several reasons. First, it corresponds to what the parties contracted for outside of bankruptcy; that is, if the company were sold outside bankruptcy and there were not enough cash to pay creditors off, senior creditors would be paid off, followed by junior creditors, and so on. If contracts are not upheld within bankruptcy, creditors, particularly senior ones, may be less willing to lend to the company in the first place. In addition, as Jackson has argued, any discrepancy between what a class of claimants receives inside bankruptcy and what it receives outside bankruptcy could lead to inefficient rent-seeking—some people bribing management into deliberately precipitating bankruptcy, and other people attempting to forestall bankruptcy.[9]

Second, the priority of a company's capital structure provides an important instrument for constraining management's ability to raise fresh capital. Under certain circumstances, for example, management may issue senior debt—which mops up earnings from assets in place—in order to restrain itself from raising further capital in the future to fund unprofitable, but empire-enhancing projects. This ability to commit to profitable projects will be weakened to the extent that the seniority of initial claims is not respected, i.e., to the extent that new claims issued at a later date are not treated as junior to existing claims in a bankruptcy procedure.[10]

Goal 4 simply captures the idea that it is better to put decisions in the hands of claimants who suffer the consequences of these decisions than in the hands of outsiders (judges, insolvency practitioners) who do not. This does not mean, of course, that the *advice* of experts may not be very useful to claimants when they make their decisions—in fact, they may simply follow this advice (for more on this, see Part V).

Although we believe that goals 1-4 have great appeal, they are not beyond question. Bankruptcy scholars have raised doubts about goal 3 in particular. Critics argue that if equityholders get little or nothing in a bankruptcy proceeding, then management—acting on the equityholders' behalf—will engage in highly risky, but inefficient, behavior when a company is close to bankruptcy, because while the shareholders gain if things go well, it is the creditors that lose if things go badly.[11]

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9. *See* JACKSON, *supra* note 3, at 21.

10. For further details, see Oliver Hart & John Moore, *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management*, 85 AM. ECON. REV. (forthcoming 1995).

11. *See* Michelle J. White, *The Corporate Bankruptcy Decision*, J. ECON. PERSP., Spring 1989, at 129, 149 (1989) ("As long as streamlining the bankruptcy procedure involves compensating creditors according to the [absolute priority rule], then managers will have an incentive to gamble with creditors'

We are skeptical about this argument. It supposes that management acts on behalf of shareholders, an assumption that may be plausible for small owner-managed companies, but which is questionable for large, public companies. The recent theoretical literature on agency costs and capital structure argues that it is more reasonable to suppose that management is self-interested.[12] Under these conditions, there is a case for making bankruptcy procedure less harsh for managers—to prevent them from engaging in highly risky behavior to save their jobs—but this is already covered under goal 2.[13]

Even in the case of small, owner-managed companies, it is far from clear that departures from absolute priority are the best way to soften the blow of bankruptcy. A better method might be to give managers and/or owners a golden parachute in the form of senior debt.

Given the above, we shall assume that goals 1-4 *are* desirable, ceteris paribus. It is worth noting, however, that the procedure we propose in Part V could easily be modified to allow for departures from absolute priority if this was found to be a desirable goal.

A final important point to make is that some of the four goals may be in conflict. For example, suppose incumbent management has special skills. In that situation, ex post efficiency (goal 1) might call for the incumbent management of a bankrupt company to be retained. However, knowing this, management might have little incentive to avoid bankruptcy, i.e., goal 2 would not be served.[14]

In view of this, it is unlikely that any bankruptcy procedure can achieve all of the four goals. The best we can probably hope for is a reasonable balance between these goals—particularly goals 1 and 2. The procedure discussed in Part V is constructed with this in mind. Although we feel that it does a satisfactory job in this respect, the procedure could quite easily be fine-tuned if the balance were felt to be wrong; we return to this point in the conclusion.

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assets as they try desperately to avoid bankruptcy's draconian treatment of equity under the [absolute priority rule].").

12. For a recent survey of this literature, see Oliver Hart, *Theories of Optimal Capital Structure: A Managerial Discretion Perspective*, *in* THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE (Margaret M. Blair ed., 1993).

13. In addition, in order to prevent managers from delaying a bankruptcy filing for too long, it may be desirable to give creditors greater powers to push a company into involuntary bankruptcy.

14. The conflict between goals 1 and 2 is analyzed in Elazer Berkovitch et al., The Design of Bankruptcy Law: A Case for Management Bias in Bankruptcy Reorganizations (University of Michigan, School of Business and Finance, Mimeograph) (1993) (on file with the *Washington University Law Quarterly*).

IV. Existing Procedures

Although there are many different bankruptcy procedures used around the world, these procedures fall into two main categories: cash auctions and structured bargaining. We discuss these in turn, paying particular attention to their application in the United States and the United Kingdom.

A. Cash Auctions (e.g., Chapter 7 in the United States or Liquidation in the United Kingdom)

In a cash auction, the company is put on the block and sold to the highest bidder. Often the company's assets are sold piecemeal, i.e., the company is liquidated. Sometimes, however, the company is sold as a going concern. Whichever occurs, the receipts from the sale are distributed among former claimants according to absolute priority.

In a world of perfect capital markets, a cash auction would (presumably) be the ideal bankruptcy procedure.[15] Anybody who could make the company profitable would be able to raise cash from some source (a commercial bank, an investment bank, the stock market) and make a bid for the company. Perfect competition among bidders would ensure that the company was sold for its true value.

In practice, there is widespread skepticism about the efficacy of cash auctions. The feeling is that a combination of transaction costs, asymmetric information, and moral hazard makes it difficult for bidders to raise sufficient cash to maintain a company as a going concern (i.e., capital markets are not perfect). As a consequence, there may be a lack of competition in the auction and few bids to keep the company whole. The result will be that some companies are liquidated piecemeal and/or sold at a low price.

It is worth spelling out a transaction-cost reason for imperfect capital markets. Suppose a large public company is put on the block. Someone making a cash bid for the company is, in effect, taking the company private (unless the bidder itself represents a public company). The bidder's intention may well be to take the company public again later. The problem is that in the interim period the bidder is bearing the risk of changes in the company's value. The bidder will, of course, "charge" for this risk-bearing by offering a lower price in the original auction. The consequence of this

15. We put in the qualification "presumably" because we are aware of no formal derivation of this result.

is two-fold. First, the going-concern bid may lose to a collection of piecemeal bids for the company's assets, since the latter achieve risk-sharing by spreading risk over a large number of bidders. Second, regardless of who wins the auction, the amount of cash raised will tend to be lower.[16]

The above transaction cost arises because of the difficulty of assembling a suitable group of investors to be risk bearers for the new company.[17] Note, however, that there is a natural group of risk bearers at hand: the former claimants (who were, after all, the previous risk bearers). Transaction costs would be reduced if bidders could reach this group directly by offering them securities in the postbankruptcy company. This is not allowed for in a cash-only auction like Chapter 7, but is a key feature of the procedure we propose in Part V (and also of Chapter 11).

Neither the above theoretical argument nor the empirical evidence described in footnote 17 provides much indication of the magnitude of the imperfections in capital markets. Given this, any bankruptcy procedure

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16. The problems of financing a cash bid will be exacerbated to the extent that other companies in the industry, which may be the natural purchasers of the bankrupt company, are also suffering from financial distress, because the shock hitting the bankrupt company is industry-wide. *See* Andrei Shleifer & Robert Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 4 (1992).

17. There is some empirical support for the idea that it is costly to find investors to put up the cash to buy a public company. One piece of evidence comes from the work on initial public offerings. This work finds significant costs of going public, at least some of which are attributable to the premium charged by investment banks for bearing the risk that the offer will not be fully subscribed. (Other costs are attributable to direct expenses and various forms of asymmetric information.) *See* Jay R. Ritter, *The Costs of Going Public*, 19 J. FIN. ECON. 269 (1987).

A second, more casual piece of evidence concerns workouts. When a company is financially distressed, it often tries to persuade its creditors to renegotiate their claims by lengthening the maturity of their debt or by swapping their debt for equity. The question is, why do creditors often go along with this, rather than pushing for bankruptcy and liquidation? It would seem that the latter strategy would be rational if a cash auction could be relied on to generate maximum value, i.e., if bidders could easily raise cash to buy the company. (Part of the desire for renegotiation can possibly be traced to the fact that most bankruptcies in the United States are filed under Chapter 11, rather than Chapter 7, and creditors may prefer to avoid Chapter 11. However, this does not explain workouts in other countries where Chapter 11 does not exist.)

A third piece of evidence comes from another area of corporate finance: takeovers. Companies taking over other companies sometimes offer shareholders a mixture of cash and securities for their existing shares. In fact, in 1993, 66% of all mergers and acquisitions with value between $100 million and $1 billion had a noncash component. *See* MERRILL LYNCH BUSINESS ADVISORY SERVICES, *Mergerstat Review* (1994). Noncash bids are harder to evaluate than cash bids, so one might expect that—particularly in a contested situation—bidding companies would prefer to offer straight cash. The fact that they do not suggests that it is difficult for them to raise cash. (There may, however, be other reasons why companies make noncash bids, such as the presence of taxes and asymmetric information.)

adopted should work well both in the case where capital markets are perfect and in the case where they are not. The procedure described in Part V has this flexibility. As we shall see, it consists of an auction in which both cash and noncash bids for the company are allowed. If capital markets are perfect, the company will go to the bidder with the highest willingness to pay—moreover, this bidder can do no better than to offer cash—and thus the outcome will be exactly the same as in a cash-only auction. On the other hand, if capital markets are imperfect, the procedure can deliver an outcome that is superior to that achievable by a cash auction.

B. Structured Bargaining (e.g., United States Chapter 11 or United Kingdom Administration)

Because of the concern about the effectiveness of cash auctions, a number of countries have developed alternative procedures based on the idea of structured bargaining. The basic idea behind these procedures is that the company's claimants are encouraged to bargain about the future of the company—in particular, whether it should be liquidated or reorganized and how its value should be divided up—according to predetermined rules. The leading example of a structured bargaining procedure in the West is Chapter 11 of the U.S. Bankruptcy Code; however, U.K. Administration is based on similar ideas, as are procedures in France, Germany, and Japan.

The details of Chapter 11 are complicated, but the basic elements are as follows: creditors' claims are stayed; claimholders are grouped into classes according to the type of claim they have; committees or trustees are appointed to represent each class; and a judge supervises a process of bargaining among the committees to determine a plan of action and a division of value for the company. During the process, incumbent management usually runs the company. An important part of the procedure is that a plan can be implemented if it receives approval by a suitable majority of each claimant class: unanimity is not required.

We remark that U.K. Administration was introduced in the 1986 Insolvency Act as "the British version of Chapter 11."[18] An important difference between U.K. Administration and Chapter 11 is that the administrator (who is an insolvency practitioner) runs the company during bankruptcy, rather than incumbent management. There are also a number of differences in the voting rules between the two procedures. To date, the

18. S.I. 1986, No. 1925, as amended by the Insolvency (Amendment) Rules 1987, S.I. 1987, No. 1919 and S.I. 1989, No. 397.

costs of Administration are such that it has rarely been used.

Chapter 11 has been subject to a great deal of criticism in the last few years. Among other things, practitioners and commentators have claimed that it is time-consuming, that it involves significant legal and administrative costs, that it causes considerable loss in the bankrupt company's value, that it is (relatively) soft on management, and that the judges who run it sometimes abuse their powers.[19]

It would undoubtedly be possible to modify Chapter 11—and procedures like it—to improve matters, and a number of suggestions along these lines have been made. However, we believe there are two fundamental problems inherent in any structured bargaining procedure that no amount of tinkering can solve. These problems are associated with the fact that a structured bargaining procedure like Chapter 11 attempts to make two decisions at once: what to do with the company, and who should get what in the event of a restructuring of claims.

Problem 1. Restructured companies do not have an objective value. Consequently, it is hard to know what fraction of the postbankruptcy company's securities each group of creditors is entitled to receive. This is true even if there is no dispute about the amount and seniority of each creditor's claim. As a result, there can be a great deal of haggling.

Problem 2. Perhaps even more serious, there is a danger that the wrong decision will be made concerning the company's future. The voting mechanism is fixed in advance, which means that those people whose payoff ought not to be affected by the outcome (either because they are fully protected anyway, or because they are not entitled to anything) may end up controlling the pivotal votes.

Problem 1 is well understood, having been discussed at some length in the literature.[20] Problem 2 has also been noted but has been subject to

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19. For some of the literature on these issues, see David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 RAND J. ECON. 157 (1988); Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355 (1990); Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241 (1989); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 758-59 (1993); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990); and Lawrence A. Weiss, Restructuring Complications in Bankruptcy: The Eastern Airlines Bankruptcy Case (Tulane University, Mimeograph) (1991).

20. *See, e.g.*, Roe, *supra* note 3; Bebchuk, *supra* note 3. The recent bankruptcy of Macy's provides a clear example of Problem 1. Senior creditors claimed that the reorganized company was worth little (implying that they should receive a large fraction of it). Junior creditors and shareholders

less analysis. An example may help to illustrate it.

Example A. Suppose senior creditors are owed $100, and the liquidation value of the company is $90. Assume that if the company were maintained as a going concern for six months then it would be worth on average $110 (suppose the discount rate is zero). However, there is uncertainty: if things go well, it will be worth $180; if things go badly, it will be worth only $40. (The average of $180 and $40 is $110.) Clearly, the value-maximizing choice is to keep the company going, since $110 exceeds the liquidation value of $90. However, it is not in the senior creditors' interest to do this. If things go well, and the company is worth $180, the senior creditors get only the $100 they are owed. But if things go badly, they get just $40. The average of these amounts is $70, which is less than the $90 the senior creditors receive from immediate liquidation.

In this example senior creditors may vote to liquidate the company immediately rather than enter into a lengthy negotiation that might lead to the company's being saved. This is in spite of the fact that there is enough value in the efficient outcome for the senior creditors to be paid off in full: $110 exceeds the $100 senior debt. Had the senior creditors been paid off, and the vote left in the hands of the junior creditors and the shareholders (whose money is at stake), then the junior creditors would have made the efficient decision about the company's future.

Things may go the other way, though. Consider a variant on Example A:

Example B. Assume the same facts set forth in Example A, except that the upside value from continuation is lower—only $120 rather than $180. Thus, the average value from continuation is $80 (the average of $120 and $40).

In Example B, the junior creditors and shareholders are not entitled to anything, since the best that can happen to the company is that it is liquidated for $90, which is less than the senior debt. So the junior creditors and shareholders ought not to be party to the decision over the company's future. And yet, the rules of Chapter 11 dictate that they do have votes, and as a result, they may be in a position to press for continuation (since they can see the upside potential of $120).[21] If the

claimed the opposite. *See, e.g.*, Patrick M. Reilly & Laura Jereski, *Macy Strategy Seems to Sway Senior Creditors*, WALL ST. J., May 2, 1994, at A4; Laura Jereski & Patrick M. Reilly, *Laurence Tisch Leads Dissent on Macy Board*, WALL ST. J., Mar. 29, 1994, at B1.

21. This is unless the cram-down procedure is adopted. *See* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 676 (1st ed. 1985). Under cram-down, junior claimants' voting rights are removed on the grounds that they would receive nothing in liquidation. *Id.* (describing the procedure of 11 U.S.C. § 1129(b) (1988)). The cram-down procedure

junior creditors and shareholders have enough votes to veto a liquidation plan, then at best the senior creditors may have to bribe them to accept it—which would lead to a violation of absolute priority—and at worst the company may be inefficiently kept going. Notice that, had the vote been left in the hands of senior creditors, they would have made the correct decision about the company's future.[22]

At this point, it is worth standing back and asking why the various claimants cannot bargain around the inefficiencies described in Examples A and B, i.e., why the Coase Theorem does not solve Problems 1 and 2. Probably the most important reason is that, in the case of large companies, there are often numerous claimants (bondholders, trade creditors, and shareholders), which can make negotiation around a given (inefficient) procedure very difficult and lengthy (due to freerider and holdout problems, combined with asymmetries of information among claimants).

Consider Example A where senior creditors might vote to liquidate the company. This outcome could be avoided if junior creditors and shareholders could bribe the senior creditors not to liquidate, e.g., they could buy out the senior creditors at a price between \$90 and \$100. However, the more numerous and heterogeneous the junior creditors and shareholders are, the more difficult it is—and the longer it will take—to coordinate such an offer (each junior claimant will want the other junior claimants to bribe the senior creditors). As a result, either an agreement will not be reached or it will require lengthy negotiation (there may be a war of attrition).[23]

Similar problems arise in Example B, where senior creditors must collectively decide to make concessions to junior claimants to compensate them for not pursuing reorganization. It may be easier to achieve

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cannot be relied upon, however; among other things, it requires an accurate judicial evaluation of the company's liquidation value.

22. The empirical work on departures from absolute priority suggests that junior claimants do indeed have enough power to force concessions from senior creditors, i.e., the problem described in Example B is relevant in practice. *See* Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989). There is less formal empirical evidence on the problem described in Example A. However, practitioners frequently mention (and write about) this problem, so it would seem to be a mistake not to take it seriously. Also, the conflict between the desire of senior creditors to terminate a bankruptcy proceeding quickly, and that of junior creditors to drag it out on the off-chance that there will be something of value for them, seems to have been a factor in the recent Macy's bankruptcy. *See, e.g.*, Patrick M. Reilly & Laura Jereski, *Media & Marketing: Macy May Seek Shorter Period for Extension*, WALL ST. J., Feb. 18, 1994, at B2.

23. For a discussion of the bargaining problems faced by companies in financial distress, see Rajesh Aggarwal, The Capital Structure Holdout Problem: Why Firms in Financial Distress Remain Overleveraged (Harvard University, Mimeograph) (1993) (on file with authors).

agreement in Example B, however, to the extent that the number of senior creditors is relatively small and the creditors find it easier to coordinate their actions.

A structured procedure like Chapter 11 reduces the severity of the above bargaining problems by making the majority's will binding on the minority (this mitigates freeriding and holdout behavior). However, even in this case, an efficient outcome may not be reached, e.g., because of asymmetries of information. Suppose, in Example A, junior claimants are unsure whether the company's liquidation value is really $90 as opposed to some lower figure, while senior creditors know the true value. Then junior creditors may quite rationally "low-ball" the senior creditors by offering them less than $90 to compensate them for not liquidating. In this case the senior creditors will turn them down if the true liquidation value is $90, and a valuable going-concern opportunity will be lost.[24]

V. AN ALTERNATIVE PROCEDURE

We can summarize the previous discussion as follows. We believe existing bankruptcy procedures are flawed for two reasons: either they assume perfect capital markets (as in Chapter 7) or they mix the decision of what should happen to the company with the decision of who gets what (as in Chapter 11). We now describe a procedure that does not suffer from these defects. The key lies in transforming a group of people with different claims (and therefore different objectives) into a homogeneous class of shareholders, and then putting the company's future to a simple vote. Our proposal also avoids bargaining over the division of the pie, because it uses a mechanical procedure for distributing shares that preserves absolute priority.[25]

The philosophy underlying the procedure—and the procedure itself—can be most easily understood in the case of a company with a single class of creditors, who are owed D by the company. Suppose the company defaults on its debt or for some other reason enters bankruptcy. The presumption is that the company is worth less than D, because otherwise it should have been able to avoid bankruptcy by borrowing or issuing new equity to pay

24. There is a vast literature on bargaining under asymmetric information. A representative article is Drew Fudenberg & Jean Tirole, *Sequential Bargaining with Incomplete Information*, 50 REV. ECON. STUD. 221 (1983).

25. However, our procedure does *not* avoid disputes over the amounts and seniorities of claims. Judges and the courts would undoubtedly have a very important role in resolving these disputes under our procedure, just as they currently do.

off existing creditors. Given this, the following bankruptcy procedure seems natural: cancel the company's debts, give all the equity to the former creditors, and let these creditors—as the new owners—decide what to do with the company, i.e., whether it should be sold off for cash or reorganized as a going concern. To this end, let the judge supervising the procedure solicit bids for the company, but permit noncash bids as well as cash bids. In a noncash bid, someone offers securities in the postbankruptcy company instead of cash; thus, a noncash bid embraces the possibility of reorganization and/or recapitalization of the company as a going concern. The following are some examples of a noncash bid:

(1) The old managers propose to keep their jobs, and offer claimants a share in the postbankruptcy company;

(2) The same financial arrangement might be offered by a new management team;

(3) The managers of another company might propose to buy the bankrupt company, offering shares in *their* company as payment;

(4) Management (old or new) might induce some debt in the company's capital structure. One way to do this would be to arrange for a bank to lend money to the postbankruptcy company (the loan is conditional on the bid succeeding), and offer claimants a combination of cash and equity in the (levered) company. Another way would be to offer claimants a combination of shares and bonds in the postbankruptcy company.

Three months are allowed for bids to be made.[26] Finally, after the bids are in, let the new owners—the former creditors—decide by a simple majority vote which bid to select. The company then exits from bankruptcy. (At this point, it may be helpful to consult the time line in Figure 1; some aspects of this time line will be explained later.)

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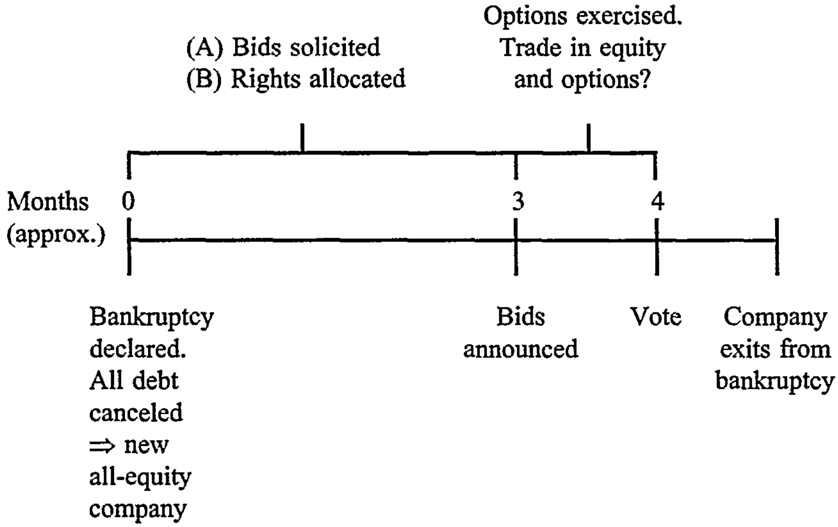
26. The scheme does not depend on this particular time horizon, and adjustments might be desirable. *See, e.g.*, discussion *infra* pp. 867-68.

Figure 1. Time line of proposed new bankruptcy procedure.



Note that, for the bidding process to work well, it is important that potential bidders have reasonably accurate information about the company's prospects. Part of the bankruptcy judge's job therefore will be to ensure that bidders have access to the company's books during the three-month bid solicitation period. Another part of the judge's job might be to evaluate, and make recommendations about, the bids, possibly with the help of appointed outside experts (e.g., an investment bank). These evaluations and recommendations would not be binding, however, and the creditors would be free to ignore them.

The above is the bare-bones description of the Aghion-Hart-Moore (AHM) procedure. Let us now discuss two elaborations. First, it is possible that the company really is worth more than *D*. This could be the case if the company was being run inefficiently by incumbent management prior to bankruptcy, but will be run efficiently postbankruptcy. Under these conditions, the above scheme overpays creditors—they get equity worth more than *D*—and initial shareholders are short-changed. In order to deal with this possibility, the AHM procedure incorporates an idea attributable to Bebchuk.[27] Each shareholder is given the option to buy out the

27. *See* Bebchuk, *supra* note 3.

creditors for the pro rata value of their debts. (That is, a shareholder who held 1% of the equity is given the right to buy back up to 1% of the equity for a price of D per 100%. Note that creditors who are bought out must relinquish their equity—they cannot hold on.)[28] These options are exercised once the bids are in—so that an assessment of the company's value can be made—but *before* the vote. An extra month is allowed for this purpose (refer again to the time line in Figure 1 above). In addition, options can be bought and sold (unexercised options expire at month four, and are thus worthless). The point of these options is simple. Any shareholder who thinks former creditors are being overpaid can do something about it; he or she can, on a pro rata basis, pay the former creditors what they are owed and get their equity in return.

Second, companies often have several classes of creditors. The AHM procedure can be extended to this case quite easily, again using Bebchuk options. Suppose, for instance, there are two classes of creditors: senior creditors owed D_1 and junior creditors owed D_2. Initially, all the equity is given to senior creditors. However, junior creditors are given options to buy equity back from the senior creditors for a price of D_1 per 100%, while shareholders are given options to buy equity back from senior and junior creditors for a price of $D_1 + D_2$ per 100%. (The scheme generalizes in a natural way to the case of *n* classes of creditors.) Again, these options are exercised after the bids are announced, but before the vote.

To see how this process works, suppose first that the best bid is perceived to value the company at less than D_1. Then no one will want to exercise their options (the junior creditors will not want to spend D_1 to get something worth less; and, a fortiori, the former shareholders will not want to spend $D_1 + D_2$), and the creditors will end up with all the equity. Suppose next that the best bid is perceived to be worth more than D_1, but less than $D_1 + D_2$. Then the junior creditors will choose to buy out the senior creditors, but the former shareholders will not want to exercise their options. Finally, if the best bid is perceived to be worth more than $D_1 + D_2$, then the shareholders will buy out both classes of creditors. It should be clear that these options preserve the absolute priority of claims even though there is no objective valuation of the company.

The other important point is that at the time of the vote, all claimholders' interests are aligned. Whether those voting are former creditors or former shareholders (who have bought out the creditors), they are now all

28. *See* Bebchuk, *supra* note 3, at 800.

shareholders and so have an incentive to vote for the highest value bid.

Of course, there may be a divergence of opinion about the value of the best bid (or indeed about which bid will win). No matter, because the scheme is decentralized, everyone can act as they wish. The more bullish people will buy out the creditors above them, and the others will not. For larger companies, markets may develop (during the fourth month) in which shares and options could be traded.[29]

Let us take a look at how our scheme operates in Examples A and B. In Example A, there are two alternatives: liquidate for $90 or keep the company going for an average value of $110. The big difference between our scheme and structured bargaining is that if the former creditors *as shareholders* get to vote, they will choose to keep the company going because they enjoy all of the potential upside gains from continuation. Of course, in this instance the former shareholders will be eager to exercise their options, since by spending $1.00 they obtain a share worth $1.10 (we are ignoring junior creditors). That is, the former creditors will get paid their $100 in full by the former shareholders, and the former shareholders, as residual claimants, will vote to maintain the company as a going concern. A good company has been saved.

In Example B, the alternatives are to liquidate for $90 or to keep the company going for an average value of $80. Here, the former shareholders will not exercise their options, and the former creditors—as the new shareholders—will vote to liquidate and receive $90. A bad company has been shut down.

Notice that Problems 1 and 2 have been resolved without eliminating the possibility of reorganization. In Example A, incumbent managers are able to retain their jobs even though they may not have the cash in hand, and any incentive on the part of the creditors to liquidate the company prematurely is avoided. In Example B, managers are rightly unable to keep their jobs. In neither example is there room for haggling. And in both

29. At the same time that our proposal was being developed, two other proposals for bankruptcy reform appeared in the literature. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); *see also* Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994). These proposals, like ours, envisage that when a company goes bankrupt the company's equity is transferred to creditors. Adler's proposal removes the right of individual creditors to foreclose on a bankrupt company's assets, while Bradley and Rosenzweig's does not. In both proposals, the company's debt is not accelerated and no bids are solicited. Also, while both proposals envisage that the transfer of control to creditors will bring about improved management, neither is very explicit about how this will happen.

examples, the people who end up voting over the future of the company are the residual claimants (i.e., those who bear the consequences of their actions); as a result, the final outcome is the value-maximizing choice.

VI. FURTHER CONSIDERATIONS

In this Part, we briefly raise some additional issues and discuss a number of practical problems that might arise under our scheme.

A. *Treatment of Junior Creditors and Former Shareholders*

In our scheme, junior creditors are required, before they receive anything, to buy out senior creditors. A concern may be that junior creditors do not have the cash on hand to exercise their options and, therefore, will be unduly disadvantaged by the need to raise cash.

We have a modification of our scheme that ameliorates this problem. Once the bids are in, the bankruptcy judge will be able to place a lower bound on the value of the company, equal to the size of the best *cash* bid, V^c (an objective amount). Given this, he or she could proceed *as if* the firm were worth V^c, and distribute shares accordingly. If V^c exceeds the amount owed to senior creditors, the junior creditors will receive a fraction of the shares in the initial distribution. For example, if the senior creditors are owed \$100, and the best cash bid that comes in is for \$150, then the senior creditors would be issued two-thirds of the shares and the junior creditors would be issued one-third. Of course, there may be a noncash bid that the junior creditors perceive to be worth more than \$150, in which case the senior creditors would still be getting too much; but in that case the junior creditors could exercise their options to buy out the senior creditors.

Of course, even with this modification, junior creditors might still be shortchanged. The worst case would be that there is *no* cash bid; here $V^c = 0$, and all the equity is initially allocated to senior creditors. How bad are things for the junior creditors in such a case? We think not too bad, for at least three reasons.

First, junior creditors do not *collectively* have to raise the cash to buy out the senior creditors. Each junior creditor can act as an *individual*. The pro rata cash injection may be quite small (indeed, an individual need not exercise his options in full; he may choose to exercise only a fraction). Second, a market for options may well develop *during* the bankruptcy process—especially for large firms. (Indeed, the bankruptcy judge might be obliged to establish such a market.) In this case, junior creditors need not come up with cash: they could simply sell their options. Third, even if some junior creditors are unable to raise the cash, and so are left empty-handed, they will probably fare no worse than they do under current arrangements.[30]

Finally, it is important to realize that the problem facing junior creditors who wish to raise cash in order to exercise their options is quite different from that of a bidder who wishes to make a cash bid for the whole company. Because junior creditors act individually, no junior creditor who exercises her option bears much risk; nor does someone who buys the option and exercises it on her behalf. In contrast, someone who makes a cash bid for the whole company may bear a great deal of risk.[31] Hence, there is no contradiction between supposing on the one hand that capital markets are sufficiently imperfect that noncash bids have a role to play, and supposing on the other hand that junior claimants will be able to obtain a reasonable fraction of the postbankruptcy pie by exercising or selling their options.

B. Claims Disputes

We have so far paid little attention to the question of how the amounts and seniorities of creditors' claims are established. The adjudication process is complex and forms an important part of any bankruptcy procedure, including our own. It may be argued that our time scale of three months is too short for the purpose of allocating shares and options.

There is a way of dealing with awkward claims disputes without jeopardizing our scheme, as long as a reasonable proportion of the claims can be established within the three months: take the claims that can be established, allocate shares and options on the basis of these claims alone,

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30. LoPucki and Whitford examined 43 firms that filed for bankruptcy in the United States after October 1, 1979, had declared assets in excess of $100 million, and had a plan confirmed by March 31, 1988. They found that the mean return to unsecured creditors was 49.5 cents per dollar, and that the median return was 38.7 cents per dollar. *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, 142 (1990).

Fisher and Martel studied 236 incorporated firms that filed for reorganization in Canada during the period 1978-87. They divided the sample into 16 "large" firms (with liabilities in excess of five million Canadian dollars) and 220 "small" firms (with liabilities below five million Canadian dollars). For large firms, the mean return to unsecured creditors was 57.7 cents per dollar, and the median return was 30 cents per dollar. For small firms, the mean return was 46.9 cents per dollar, and the median return was 35 cents per dollar. *See* Timothy C.G. Fisher & Jocelyn Martel, Facts About Financial Reorganization in Canada (University of Montreal, Mimeograph) (1994) (on file with the *Washington University Law Quarterly*).

31. See the discussion in Part IV, *supra*, about the transaction costs of making a cash bid.

carry out the vote, and emerge from bankruptcy with the contentious claims still outstanding. Once these claims have been decided, there could be an appropriate ex post settling up—with the claimants being given securities in the postbankruptcy company.[32] Notice that the people with contentious claims do not participate in the vote, but this is not too serious, since one may presume that they too would have voted for the value-maximizing bid.[33]

In other words, we do not agree with those commentators who have argued that the complexity of the adjudication process favors a liquidation procedure like Chapter 7 over a reorganization procedure like Chapter 11 or like ours.[34] Their point is that if a company is liquidated for cash, then the cash can be held in an interest-bearing escrow account and disbursed when the claims are resolved. We would argue that something similar can be done in the case of a reorganization plan. If a noncash bid is voted in, any subsequent dividends or debt repayments can be placed in an escrow account and distributed, along with fresh equity, once the claims are resolved.

To put it another way, we think that a bankrupt company is not so different from a solvent company that has uncertain claims against it. If there is a threat of a tort claim, a solvent company carries on operating until the tort claim is resolved and ex post settling up occurs. The company is not liquidated just because a tort claim *may* be established in the future.

C. *Urgent Cases*

For some kinds of businesses, the worry may be that three to four months is too long a period, rather than too short. This is particularly true of companies with customers and suppliers that, unless the uncertainty is resolved quickly, will shift elsewhere.

There may be a case for granting the bankruptcy judge discretion to speed up the process; that is, to hold the vote sooner. The drawback is that there may be less information available at the time of the vote, and a

32. There are several ways of doing this; one is to give new claimants the same securities that equivalent creditors elected to hold as a result of the bankruptcy process.

33. We are oversimplifying a little here. Those shareholders who think a senior claim may materialize later have an incentive to choose a risky reorganization plan since they gain if things turn out well and do not suffer if they turn out badly. See Example B *supra* pp. 859-60 for a similar phenomenon.

34. *See, e.g.*, Michael C. Jensen, *Corporate Control and the Politics of Finance*, J. APPLIED CORP. FIN., Summer 1991, at 13, 32 (advocating auction-oriented bankruptcy reform).

number of claims may still be outstanding. But, as we have explained above in subpart B, this need not be fatal to the efficacy of our procedure.

To safeguard against abuse, it would probably be desirable to limit the bankruptcy judge's discretionary powers to cases in which he had clear evidence that the normal timetable would severely jeopardize creditors' claims or the future of the business.

D. Treatment of Secured Creditors

We propose that a secured creditor's collateral be appraised. If the appraisal value is greater than the debt, the creditor should simply be treated as if all his debt was senior—i.e., he should be allocated shares, not options. If his debt is less than fully secured, then he is given an appropriate mix of shares and options. We do not believe that secured creditors should have the right to seize collateralized property (unless it can be shown to be unnecessary to the company's reorganization), since this could lead to an inefficient dismantlement of the company's assets through a "me-first" grab. Note that this is also the position taken by current U.S. bankruptcy law.[35]

Of course, we realize that there is a tension between the view that a secured creditor's rights to seize assets should be restricted and the view, which we also hold, that private contracts should be upheld (the secured creditor's contract may have included the right to seize assets). In some cases, there may be efficiency gains from letting an outside party *exercise* its right to seize a specific asset. Note that the parties may be able to achieve something like this arrangement—even under our scheme—by making the outside party the owner of the asset and having the company rent the asset from him. In this case, if the company goes bankrupt, the outside party might be in a stronger position to repossess its property (a bidder for the company could, of course, negotiate with the outside party for the continued use of the asset if this were desirable).[36]

E. Who Runs the Company During Bankruptcy?

In Chapter 11, incumbent management typically runs the company during bankruptcy. An alternative is for a trustee to run the company, as in old Chapter X of the U.S. Bankruptcy Code. Clearly, this is an important issue

35. *See* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY § 8(c) (1992).

36. In practice, however, U.S. bankruptcy law puts restrictions on the rights of owners to repossess property from a bankrupt company. *See* 11 U.S.C. § 365 (1988).

for *any* bankruptcy procedure. Notice that our procedure can be applied regardless of how this issue is resolved.

F. Debtor-in-Possession Financing

The viability of certain kinds of bankrupt companies (such as retail stores) can depend to a great extent on management being granted debtor-in-possession financing, whereby suppliers' credit is placed ahead of existing (unsecured) senior debt. (Ensuring this financing is often mentioned as an important role played by Chapter 11.) There is no reason why a comparable arrangement could not be used during the four months of our proposed bankruptcy process, with the judge's approval.

G. Partial Bids

We have implicitly assumed that the bids received are for the *entire* company. In fact, bids may be for parts of the company. The problem then arises as to how to deal with overlapping or inconsistent bids. Before a vote can be taken, a menu of coherent options has to be assembled.

We think that it makes most sense to leave the matter of assembling "whole" bids in the hands of the judge and his or her appointed agents. It may well be necessary to solicit supplementary bids for parts of the company, in order to package a whole bid.[37] Although this seems messy, it should be noted that a similar difficulty—how to bundle or unbundle the assets of the company so as to maximize cash receipts—is faced in a Chapter 7 proceeding.

H. Voting Procedures

Another issue concerns the voting procedure per se. If there are only two bids, it seems natural to have a simple vote between them. However, with more than two bids, there are many possibilities. Shareholders could cast their votes for their most preferred plan, with the plan that receives the most votes being the winner; or shareholders could rank the plans, with the plan that receives the highest total ranking being chosen; or there could be two rounds, in which shareholders rank the plans in the first round, with a subsequent runoff between the two highest-ranked plans in the second round. One point to note is that thorny issues in voting theory (such as the Condorcet Paradox) are less likely to arise in the present context, given that shareholders have a common objective: value maximization.

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37. Another possibility is to put the onus of assembling whole bids on the bidders themselves, i.e., a bidder for part of the company would have to find someone else to bid for the complementary part.

I. Small Companies

Our scheme is likely to be most valuable in the case of medium to large companies with multiple creditors, for which bankruptcy raises the thorniest problems. However, most bankruptcies relate to small companies, for which a bank is typically the single main creditor. Under our scheme, the bank would get all the equity (presuming that it is not bought out) and could "vote" on whether to liquidate or reorganize the company. In addition, our scheme allows junior creditors—e.g., trade creditors—to buy out the bank; trade creditors might have an incentive to vote to keep the company going because they anticipate profitable trade with the company in the future. In short, our scheme may also have a role to play in the case of small companies.

J. Workouts

Many of the problems of bankruptcy plague company workouts. There is no reason why companies could not, of their own accord, choose our scheme as a vehicle for facilitating such workouts.

VII. CONCLUDING REMARKS

First, it is worth repeating what we see as the main point of this Article. Current reorganization procedures are flawed because they mix the decision of who should get what with the decision of what should happen to a bankrupt company. We have proposed a procedure that separates these two issues.

Second, it may help to say a few more words about the philosophy underlying our procedure. Our view is that a bankrupt company is not fundamentally different from a solvent company that is performing badly. In the case of a solvent company, shareholders elect a board of directors who are entrusted with deciding, on a day-to-day basis, whether to keep the company going, sell it, or close it down. We believe that the same menu of options should be available to the claimants of a bankrupt company. In other words, we do not see why bankruptcy should automatically trigger the termination of a company via a cash sale (either as a going concern or in pieces). We see bankruptcy as an indication that something is wrong with *management* rather than with the company itself. The appropriate response is to allow new management teams the opportunity to replace existing management. Our scheme does this through the device of a noncash bid. Noncash bids allow for Chapter 11-type reorganization plans.

However, in our scheme, unlike in Chapter 11, the company's future is decided by a simple vote—a procedure that is standard for solvent companies—rather than by a complex bargaining procedure that is never seen outside bankruptcy.

An interesting insight into how our scheme might work is provided by the recent takeover battle for Paramount. There were two bidders for Paramount—Viacom and QVC—and each put in a bid with a noncash component as well as a cash component. Paramount shareholders chose between the bids—and the option of keeping Paramount independent—by what was in effect a vote. (Viacom won the vote.) Thus the choice Paramount shareholders were asked to make is analogous to the choice claimants would make in our scheme in the presence of noncash bids.

We noted in Part III that a good bankruptcy procedure should balance two goals: one is to achieve an ex post efficient outcome, the other is to be neither too hard nor too soft on incumbent management (so as to encourage the appropriate behavior prior to bankruptcy). We believe that our procedure does a reasonable job of balancing these objectives. Note, however, that the procedure can be modified to be softer or harder on incumbent management (at some probable cost in terms of ex post inefficiency), if that is thought to be desirable. For example, incumbent management could be *favored* by handicapping other bidders in the auction—e.g., the auction rules could state that an outside bidder has to win more than two-thirds of the votes. (Another way to soften the blow of bankruptcy is to give managers a golden parachute in the form of senior debt in their company.) Conversely, management could be disfavored by a requirement that *they* must win more than two-thirds of the votes to retain their jobs.

Finally, it is worth repeating a point we made in Part IV. A good bankruptcy procedure should work well both when capital markets are imperfect and when they are perfect. Our procedure has this feature. If capital markets are perfect, the company will go to the bidder willing to pay the highest amount—moreover, this bidder can do no better than offer cash—and thus the outcome will be exactly the same as in Chapter 7. For this reason, while believers in perfect capital markets may not see the merit of our scheme relative to Chapter 7, they should not be strongly opposed to it. In contrast, those with doubts about the adequacy of capital markets should, we feel, find value in the scheme.