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Articles

Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory

Stephen J. Lubben*

I. Introduction

Almost since the day of its enactment, Chapter 11 of the United States Bankruptcy Code[1] has been the subject of a bevy of

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The reader should be advised that I am presently employed as an associate in the corporate restructuring department of a leading New York-based law firm. I represented a party in interest in certain of the cases cited herein, but all information contained in this article is based solely upon publicly available material. The opinions expressed in this article are my own, and must not be taken to reflect the opinions of my employer or any current or former client.

1. 11 U.S.C. §§ 1101-1174 (1994).

law review articles urging either its drastic overhaul or complete repeal.[2] The salvos only increased with the recession of the early nineties, and the resulting boom in Chapter 11 filings. Leading scholars from virtually every major law school, typically approaching the debate from a law and economics perspective, have taken aim at Chapter 11 for over twenty years now.[3] Their efforts have failed.

Chapter 11, by and large, remains unchanged since its enactment.[4] The only significant change to the statute that Congress has seriously considered in recent years turns on whether or not Delaware should lose its privileged status as the home to most very large Chapter 11 cases.[5] Proposals to dramatically revamp Chapter 11's structure, or to repeal Chapter 11 in order to encourage more liquidations, have had little discernable effect.

To be sure, the critics of Chapter 11 have not promulgated their views without remark; numerous scholars have argued that a pure efficiency analysis—especially when efficiency is equated with near effortless debt collection—undervalues the larger policies behind reorganization of corporate debtors.[6] The efficiency critics

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2. *E.g.*, Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy,* 111 YALE L.J. 83 (2001); 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); Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173 (1987) [hereinafter Baird, *World Without*]; Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986) [hereinafter Baird, *Corporate Reorganizations*]; Lucian Ayre Bebchuk & Jesse M. Fried, *A New Approach to the Valuation of Assets in Bankruptcy,* 114 HARV. L. REV. 2386 (2001); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

3. *See supra* note 2.

4. The current Bankruptcy Code was enacted in 1978. The best account of the early bankruptcy laws in this country remains C. WARREN, BANKRUPTCY IN UNITED STATES HISTORY (1935).

5. *Cf.* Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967 (1999); Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231 (2001); Robert K. Rasmussen & Randall S. Thomas, *Whither the Race: A Comment on the Effects of the Delawarization of Corporate Reorganizations,* 54 VAND. L. REV. 283 (2001).

6. Elizabeth Warren has been the most prominent member of this group of scholars. *See, e.g.*, Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 788 (1987) ("Congress intended bankruptcy law to address concerns broader than

of Chapter 11 have more often than not simply deflected these criticisms by either proclaiming that the proponents of non-efficiency concerns bear the burden of justifying inclusion of these factors in the analysis of the statute,[7] or by asserting that non-efficiency concerns belong to the realm of non-bankruptcy law.[8] The heretics disarmed, the critics return to the quixotic task of heralding Chapter 11's inadequacies to a world that does not seem to be listening.

Why the extreme disconnect between theory and reality?[9] In this article I argue that some of the harshest critics of Chapter 11 exhibit little understanding of the complex financial structure that even a modestly large debtor typically possesses. This lack of understanding has led the critics of Chapter 11 to propose bankruptcy theories that suffer from serious technical and conceptual problems that call into question the utility of these theories.

On one hand, the statute's critics are clearly tapped into at least the basics of finance theory, as taught in law schools and the early days of business schools, but, on the other hand, the same authors show little understanding of the complex nature of corporate finance in the messy world of firms on the brink of financial collapse. Thus the critics of Chapter 11 have failed to move beyond the firm of textbook hypotheticals—where all firms

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the immediate problems of debtors and their identified creditors; they indicate clear recognition of the larger implications of a debtor's wide-spread default and the consequences of permitting a few creditors to force a business to close."); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 478 (1992) [hereinafter Warren, *Untenable Case*]. Lynn LoPucki has also played a key role, not only by providing important empirical evidence that has often reshaped the debate, *see, e.g.*, Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993), but also by probing the viability of some of the leading reform proposals, *e.g.*, Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999) [hereinafter LoPucki, *Contract Bankruptcy*]; Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992) [hereinafter LoPucki, *Strange Visions*].

7. Adler, *supra* note 2.

8. Baird, *World Without*, *supra* note 2, at 174.

9. My goal is *not* to add my voice to the chorus decrying abstraction in legal literature. I accept that a good portion of the articles published in law reviews today, especially those written by tenured professors, do not aim to affect policy in any direct manner, but are instead part of an ongoing theoretical debate among the law school sages. All the same, when a debate completely loses it mooring in reality—as I argue the debate over Chapter 11 theory has—it risks losing any vestige of significance.

are comprised of three classes of claimants: senior creditors, junior creditors, and equity—to the real world in which even a holding company can have over a dozen classes of claimants.[10]

The failure to connect theories developed in a world populated by purely hypothetical firms to a more complex reality has lead to the production of concepts that have little import beyond academia. This failure has lead to the continued production of theories that remain "almost defiantly far removed from reality."[11]

In Part II of this article, I briefly summarize and critique three leading proposals for reforming corporate reorganizations.[12] This part of the article demonstrates how leading articles by Professors Bebchuk,[13] Schwartz,[14] and Adler[15] reflect little appreciation of how debtors are financed, and the reasons for this financing.[16] In Part III, I then extrapolate a general critique of reorganizational theory from these and other leading Chapter 11 reform projects.[17] In Part IV, I ultimately conclude that, while it should be possible to support an efficiency based conception of corporate reorganization, the attempts to do so to date suffer from identifiable internal and external weaknesses that doomed them from their inception.

My point is not to uniformly reject the use of societal efficiency as a basis for examining corporate reorganization or to defend the current state of Chapter 11. There is clearly much room for improvement, and certainly some previous articles proceeded in the mistaken belief that identification of the diverse congressional policies currently encased within the Bankruptcy Code serves as a justification for the presence of these policies in the Code. In short, rather than attempting an assault on any particular view of Chapter 11, the main function of this article is to emphasize the shortcomings in one potentially promising view of Chapter 11.

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10. *E.g.*, Debtor's Mem. in Supp. of Confirmation of Plan of Reorganization *In re* Home Holdings, Inc., No. 98-B-40319 (Bankr. S.D.N.Y. 1998) (on file with author) (debtor's memorandum in support of confirmation of plan, which describes a plan of reorganization with eleven primary classes, with class four divided into five sub-classes).

11. Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1287 (1994).

12. *See* discussion *infra* Part II.

13. *See* discussion *infra* Part II.A.

14. *See* discussion *infra* Part II.B.

15. *See* discussion *infra* Part II.C.

16. *See supra* notes 15-17.

17. *See* discussion *infra* Part III.

II. Three Specific Conceptions of Chapter 11

Western jurisprudence has a long history of criticism based upon revealing the unrealistic facets of any given theory. This article joins in that tradition and extends it to bankruptcy.[18] This section of the article examines the specific failings of three leading Chapter 11 reform proposals: Lucian Bebchuk's option-based approach,[19] Alan Schwartz's contract theory approach,[20] and Barry Adler's "Chameleon Equity" approach.[21] The goal is to illustrate the significant problems with the leading theories, and the multitude of issues that remain unaddressed, without retreading ground that has been covered in the substantial body of academic literature on this subject.

Professor Bebchuk's proposal was chosen because it is one of the few systems that purports to be applicable within the existing Chapter 11 framework.[22] It has inspired other authors to offer refinements of Bebchuk's original structure,[23] and he has continued to refine the proposal himself.[24] The other two works are more radical: Professor Adler's "Chameleon Equity" system would require major amendments to a host of non-bankruptcy law, and Professor Schwartz's system would require all creditors of a firm to consider their bankruptcy preferences at the point of first interaction with the debtor. Taken together, these three articles represent the state of the art in academic conceptions of corporate reorganization.

18. *See, e.g.*, Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809 (1935); Lon L. Fuller, *Positivism and Fidelity to Law: A Reply to Professor Hart*, 71 HARV. L. REV. 630, 662-63 (1958); *see also* Stephen J. Lubben, *Chief Justice Traynor's Contract Jurisprudence and the Free Law Dilemma: Nazism, the Judiciary, and California's Contract Law*, 7 S. CAL. INTERDISC. L.J. 81 (1998) (discussing the German Free Law Movement).

19. *See supra* note 13.

20. *See supra* note 14.

21. *See supra* note 15.

22. *See supra* note 13.

23. *See* Aghion et al., *supra* note 2, at 539.

24. *E.g.*, Lucian Ayre Bebchuk, *Using Options to Divide Value in Corporate Bankruptcy*, 44 Eur. Econ. Rev. 829 (2000) [hereinafter Bebchuk, *Using Options*]; Lucian Ayre Bebchuk, *Chapter 11*, Nat'l Bureau of Econ. Research, *available at* http://www.nber.org/papers/6473 (Mar 1998) [hereinafter Bebchuk, *Chapter 11*].

A. *Lucian Bebchuk, "A New Approach to Corporate Reorganizations"*[25]

Under Professor Bebchuk's Chapter 11 reform proposal, each of the debtor's claimants would be granted a transferable option on the debtor.[26] The option would entitle the holder to buy a portion of all higher priority claims or interests, with the lowest priority claimants having the first opportunity to exercise their options.[27] If the members of every tranche of debt and equity failed to exercise their options, the highest priority claimants would obtain ownership of the debtor.[28]

Bebchuk illustrates his proposal through a simple example of a company with an overall value (*V*) that is unknown.[29] The debtor has three levels of claimants: Class A includes 100 senior creditors, each owed $1; Class B includes 100 junior creditors, each owed $1; Class C includes 100 shareholders, each holding one unit of equity.[30]

Each Class A creditor receives one type-A option right.[31] The company may redeem a type-A right for $1.[32] If the right is not redeemed, its holder will be entitled to receive one unit of the reorganized company (*RC*).[33] Each Class B creditor will receive a type-B right.[34] The debtor may redeem a type-B right for $1.[35] If the right is not redeemed, its holder will have the option to purchase one *RC* unit for $1.[36] Each Class C shareholder will receive one type-C right.[37] The company may not redeem a type-C right.[38] The holder of a type-C right will have the option to purchase one *RC* unit for $2.[39] Thus, beginning with the lowest priority claimants, each class has the opportunity to either buy out the senior classes, or forgo any recovery from the debtor.[40] If the

25. 101 HARV. L. REV. 775 (1998).
26. *Id.* at 781-88.
27. *Id.*
28. *Id.*
29. *Id.* at 785.
30. *Id.* at 781-82.
31. *Id.* at 786.
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.* at 786-88.

most senior class is not "bought out," it obtains ownership of the debtor.[41]

This option ladder is designed to avoid the need to value the debtor, which Bebchuk describes as the most significant problem of Chapter 11.[42] No particular value is needed. Instead, creditors and shareholders receive a recovery that reflects their claims as a function of *V*.[43] Creditors lacking the liquidity or desire to participate in the reorganized company can sell their options to third parties.[44]

Bebchuk argues that it is highly unlikely that only a fraction of any class of options would be exercised, because "in the presence of market trading, the rights should all end up at the hands of the optimists, who would use them; no rights would remain idle in the hands of pessimists to whom the rights are of no use."[45] Bebchuk does not explain why the optimists would want to obtain all of the *RC* units of the reorganized debtor, when a simple majority of the units would apparently suffice.[46] Even at a nominal price, buying excessive options would appear to be irrational. Moreover, in the presence of heterogeneous valuations, once an optimistic party had obtained a majority position in a class, the remaining rights could well decline precipitously in value, to the point that only the majority stake would be tendered.[47]

The potential for partial redemptions of options exposes Bebchuk's theory to the need to value the debtor, the very problem that the theory was designed to avoid. Bebchuk explains that, assuming partial redemption of options could occur, "money received from the exercise of type-C rights will be used half for pro rata redemption of type-A rights and half for pro rata redemption of type-B rights."[48] Class A creditors, however, can be expected to argue that this distribution does not satisfy their claims in full, and that they are therefore entitled to some portion of Class B's

41. *Id.* at 787.
42. *Id.* at 777-81.
43. *See id.* at 784-85.
44. *Id.* at 786.
45. *Id.* at 788 n.33.
46. Bebchuk also argues that no type-C rights would be purchased if type-B rights remain available, *id.*, but type-C rights are the only rights that fully ensure control over the reorganized debtor, as they are not redeemable by the debtor. *Id.* at 786. Thus, if the purchaser strongly values control—perhaps as a result of the presence of large private benefits—C-type rights may be more valuable than B-type rights.
47. *Id.* at 803; Roe, *supra* note 2, at 575.
48. Bebchuk, *supra* note 2, at 788.

distribution. This problem is not solved by giving all of the cash to Class A, because the *RC* units still need to be distributed between Class A and B.

A short example illustrates the point. Consider a firm with a capital structure only slightly different from that discussed by Bebchuk:[49] Class A includes 200 senior creditors, each owed $1; Class B includes 100 junior creditors, each owed $1; Class C includes 100 equity holders, each holding one unit of equity. Assume that a party, utilizing the market for options that Bebchuk envisions, obtains a majority (51) of the Class C options. This party tenders these options, paying the reorganized firm the requisite $3 per *RC* unit in the new entity. No other party tenders option rights.

The reorganized firm thus has $153 in cash, and 49 remaining *RC* units, to distribute to Classes A and B. At this point, it seems plain that Bebchuk's assertion that "money received from the exercise of type-C rights will be used half for pro rata redemption of type-A rights and half for pro rata redemption of type-B rights" would violate the absolute priority rule, as Class A is entitled to full payment before Class B receives anything.[50] Thus, all of the cash will be paid to class A, but the remaining 49 *RC* units must now be divided between Class A and B. This division can only take place, however, if some value is placed on the *RC* units.

It could be argued that, by failing to bid in the initial auction, the Class B bidders have tacitly acknowledged that the *RC* units are worth less than $2 per share, and thus the Class B bidders have forfeited their right to participate in the reorganized firm. Class A, however, will be receiving the cash, and is thus entitled to recover only an additional $47 from the debtor. The absolute priority rule —or, in Chapter 11 parlance, the "fair and equitable" rule[51]—works both ways: no lower priority claimant is entitled to any recovery until all senior claimants have been paid in full, but the senior claimants are not entitled to recover any more than 100 cents on the dollar.[52] Thus, if the Class B claimants value the *RC* units at *x*,

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49. *See infra* pp. 105-06.

50. *See* Bebchuk, *supra* note 2, at 788.

51. 11 U.S.C. § 1129(b) (1994).

52. *See In re* MCorp Fin., Inc., 137 B.R. 219, 235 (Bankr. S.D. Tex. 1992) ("[F]or a plan to be confirmed when stockholders are eliminated, creditors must not be provided for more than in full."); *see also* 11 U.S.C. § 1129(b)(2) (1994) (plan must be "fair and equitable" to be approved over the vote of a dissenting class); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) ("fair and equitable" means that a plan must "comply with the absolute priority rule").

where \$0.47 < x < \$2, the Class B claimants can legitimately claim that the forfeiture approach violates the absolute priority rule.[53]

Indeed, any attempt under the Bebchuk system simply to award the *RC* units to the most senior unpaid class would likely result in vehement protests from any unpaid lower priority classes, and the system would eventually dissolve in a morass of litigation. In short, absent either full redemption of a class of options, which may not occur if a party has secured a majority position in a class, or a remarkable inter-creditor rapport, valuation of the *RC* units (and thus the debtor) will be inevitable, and thus the very problem Bebchuk identifies as the key failing of Chapter 11 remains at issue.

Moreover, the system is based upon the assumption that the debtor's total liability is easily ascertainable. Bebchuk touts the benefits of his approach by blithely proclaiming that "[o]nce a company enters reorganization, it will be *only* necessary to determine all the claims outstanding against the company and to fix the capital structure that the reorganized company will have."[54] Of course, as any bankruptcy practitioner realizes, determining the full extent of a debtor's liabilities can consume a substantial portion of the time spent working on a case.

The time spent preparing the debtor's schedules of assets and liabilities, setting a bar date, reviewing filed proofs of claim, litigating claims objections, and generally determining who is owed what and in what priority can easily represent a large share of the billable hours in any Chapter 11 case, and could easily take months to complete.[55] Given that Bebchuk's proposal demands awaiting the outcome of this process, it is an open question whether his system of options will resolve cases with any greater speed than presently seen in Chapter 11.

Finally, this system suffers from the flaw, habitual among academic conceptions of corporate bankruptcy, of assuming that creditors invariably fall neatly into their respective levels of priority.[56] For example, a debtor may have two tranches of publicly

53. If the Class B claimants know that they are bidding on a minority stake in the firm, the spread between the Class C bidders' valuation of \$3 per *RC* unit and the Class B bidders' valuation of x becomes quite understandable.

54. Bebchuk, *Chapter 11*, *supra* note 24, at 13 (emphasis added).

55. The tendency of Chapter 11 theorists to illustrate their proposals with debtors whose sole creditors are bondholders might explain the failure to appreciate the magnitude of this issue. Real debtors are, of course, faced with a multitude of creditors, comprised of trade creditors, litigation claimants, current and former employees, and governmental units, to name but a few.

56. *Accord* Douglas G. Baird & Robert K. Rasmussen, *Control Rights,*

held unsecured debt, the second subordinated to the first. Typically, however, the subordination clause in the junior indenture will only apply with respect to the senior bondholders. With respect to trade creditors, the junior bondholders are *pari passu*. The trade creditors, however, are not bound by the subordination clause, and are thus *pari passu* with the senior bondholders.

Bebchuk's proclamation that "the division of the reorganized company's securities will follow automatically and swiftly from the option scheme's principles"[57] would likely ring hollow to the clearing agent assigned to decide in the first instance whether the trade creditors should get type-A or type-B option rights in the debtor. Even if the trade creditors were placed in a distinct class, the disbursing agent would have to determine the order in which the various options could be exercised, which is no easy task given the relative nature of the priorities at issue.

In short, the capital structure hypothesized by Bebchuk's theory does not reflect a real life capital structure. This system is unable to handle conflicting creditor priorities or disputed debtor liabilities and may even run afoul of the absolute priority rule in certain circumstances. While his program presents an interesting intellectual game, the failure to connect the theory to practical corporate finance renders any benefits illusory.

B. *Alan Schwartz, "A Contract Theory Approach to Business Bankruptcy"*[58]

Professor Schwartz has proposed a system of *ex ante* bankruptcy contracting in place of the current largely mandatory bankruptcy scheme. Schwartz argues that bankruptcy contracts would be more efficient than Chapter 11, even though "[a] firm may have numerous creditors; these creditors may lend at different

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Priority Rights, and the Conceptual Foundations of Corporate Reorganizations, 87 VA. L. REV. 921, 939 (2001) ("The case for absolute priority is strongest with respect to modern, large, publicly traded firms with their neatly hierarchical capital structures.").

57. Bebchuk, *Chapter 11, supra* note 24, at 13.

58. 107 YALE L.J. 1807 (1998). For a detailed critique of this article, see Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999). Professor Schwartz replied to LoPucki's critique in Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343 (1999) [hereinafter Schwartz, *Bankruptcy Contracting*]. Professor LoPucki's general theme is that, even if Schwartz's assumptions are taken at face value, the article itself is internally inconsistent. I concur with a great deal of Professor LoPucki's analysis and will not repeat his points here, except to the extent that they overlap with my own.

times; and they may have different preferences about bankruptcy systems."[59]

To support this bold claim, Schwartz first examines a case in which all creditors contract with the debtor at the same point in time. Two bankruptcy options are assumed to exist at this point.[60] One, denoted R, is much like Chapter 11. The second system, denoted L, provides for the sale of insolvent firms, or the assets of these firms, at auction. Under some circumstances, it will be optimal for the firm to use system R, but under other circumstances, system L will be better.[61] Both systems rigorously follow the absolute priority rule, and the parties are free to contract for either system.[62]

Parties must choose from among three contract types. The first type, which Schwartz refers to as a "renegotiation contract," resembles current debt agreements in that the bankruptcy system is not specified, and the debtor is free to choose the bankruptcy system it favors *ex post*.[63] In the second type of contract, termed "renegotiation-proof," the creditors authorize the firm to keep a portion of the monetary return that would be generated by whatever bankruptcy system it chooses.[64] The aim of this contract is to align the firm's interests with those of the creditors, meaning the bribe paid to the debtor must outweigh the benefits to the firm of making an inefficient choice.[65] The third type of contract that Schwartz proposes is the "partially renegotiation-proof contract," where the preferred bankruptcy system is determined on the basis of an outside signal.[66]

Schwartz then demonstrates that, in a world where all creditors contract with the debtor simultaneously, a renegotiation-proof contract, assuming an appropriately set bribe, would induce the firm to make the optimal choice of bankruptcy systems, because the sum of the private benefits and cash payments the firm would

59. Schwartz, *supra* note 58, at 1822.

60. *See id.* at 1823.

61. Professor Schwartz assumes that all parties can determine, *ex post*, which system would be more efficient. As discussed, *infra*, the basis for this assumption is, at best, confusing.

62. Schwartz, *supra* note 58, at 1823.

63. *Id.* at 1830.

64. *Id.* at 1827.

65. As I note, *infra*, Professor Schwartz assumes a unity of interest between management and shareholders.

66. Schwartz, *supra* note 58, at 1831. This contract will be renegotiated when the signal fails to predict an appropriate system. *Id.*

obtain would always overcome the benefits to the firm of making the non-optimal bankruptcy choice.[67] Since firms rarely lend at only one moment, Professor Schwartz then moves to consider a diachronic model.

At this second stage, the model contemplates two creditors who contract with the firm sequentially and assumes that the optimal bribe may vary.[68] To extend the model in this manner, Schwartz must overcome two key problems: the need to account for later changes in the degree of the optimal bribe, and variations with regard to which contract type is most desirable. Moreover, for the model to have any semblance of practical relevance, Schwartz must also address the potential for conflicting preferences among creditors with regard to the choice between bankruptcy systems.[69]

To solve these problems, Schwartz first incorporates an uncomplicated two-part conversion device. The conversion term first provides that "the bribe in the first contract will convert to the bribe in the second contract."[70] Then, the conversion term provides that all contracts will automatically "convert (only as regards bankruptcy) to the contract type that is currently optimal for the firm."[71] Taken together, the conversion term provides that the last contract a debtor signs before bankruptcy will govern the level of optimal bribe and the choice of bankruptcy contracts. Thus, if the last creditor to negotiate with the debtor bargains for a renegotiation-proof contract, with a bribe of 10% of the creditor's recovery, all creditors will automatically be parties to similar agreements with the debtor.

To overcome the problem of conflicting creditor preferences between liquidation and reorganization, and the potential that certain creditors (*e.g.*, trade creditors) will always favor reorganization and demand "reorganization contracts," Schwartz offers a two-part solution. First, he argues that the rigorous enforcement of the absolute priority rule that his system assumes will dispatch most creditors' conflicts, because, recognizing that senior creditors must be paid in full before they will recover

67. *Id.* at 1832.

68. *Id.* at 1834.

69. Note that, because Professor Schwartz assumes all parties comprehend which system is efficient, he does not consider the case of a party that erroneously favors one system over another.

70. Schwartz, *supra* note 58, at 1834.

71. *Id.* This apparently means that in certain instances the second part of the conversion term will negate the first part of the conversion term, as the optimal contract might be a "renegotiation contract," which entails no bribe.

anything, junior creditors will prefer the system that maximizes overall returns.[72] Second, he argues that in the case of trade creditors and others who may prefer to keep the debtor in business in hopes of engaging in future transactions with the debtor, the choice of bankruptcy contract types (and hence bankruptcy systems) should be governed by majority rule.[73] Although not clear in his original article, Professor Schwartz has since clarified that he intends for the majority to be determined on the basis of the face amount of the debt.[74] He further assumes that trade creditors will typically be in the minority under such a voting scheme. Having thus illustrated that it would be possible for a complex firm to contract with its creditors for a bankruptcy scheme, Professor Schwartz bemoans the inability to enter into these contracts under present law.[75]

Professor LoPucki has previously noted several contradictions between the "last contract" rule in this system, and the majority vote provision. Professor Schwartz has addressed some of these points in a later article, but several issues remain unresolved. For example, it is not clear if the "last contract" rule is subject to any limitations. If not, the smallest of contracts (*e.g.*, an agreement to lease a copy machine) could determine the optimal bribe and contract type for all of the firm's creditors.[76] The debtor, and its management, would have a strong incentive to time the bankruptcy filing in relation to a favorable agreement. Indeed, the debtor would have an incentive to enter into unneeded agreements simply to rework its fate in bankruptcy.

More generally, it is not clear how the majority of creditors will be determined temporally. Schwartz proclaims that "a trade creditor who prefers an inefficient bankruptcy contract should also be bound to the bankruptcy bargain that the *ex ante* majority prefer."[77] But when is this *ex ante* majority to be determined? Because the composition of an *ex ante* majority could fluctuate over time—as creditors are paid and new creditors join the pool—this aspect of Schwartz's model could again lead the debtor to manipulate the timing of a bankruptcy filing. In his reply to Professor LoPucki, Schwartz makes clear that he assumes that trade

72. *Id.* at 1837-38.
73. *Id.* at 1838.
74. Schwartz, *Bankruptcy Contracting, supra* note 58, at 360 & n.28.
75. Schwartz, *supra* note 58, at 1838-39.
76. *Cf.* Lynn M. LoPucki, *supra* note 58, at 326.
77. Schwartz, *supra* note 58, at 1838.

creditors will always be in the minority, and thus the "majority rule" approach may be nothing more than a "bondholders rule" approach.[78] In a firm where small unsecured creditors were closely matched with other, larger creditors—consider a firm that was financed with a large amount of equity—Schwartz's approach would seem to require constant polling of the creditors as the firm encounters financial distress, the very time when the firm is unlikely to be able to afford this undertaking.

The assumption that rigorous enforcement of the absolute priority rule will negate conflicts among senior and junior bondholders is also doubtful. If a class of junior bondholders is entirely "underwater," it will matter little to the class that liquidation might be more efficient.[79] Reorganization offers the prospect, however slight, of obtaining some recovery.[80] As basic option theory teaches us, when the junior bondholders are faced with a certainty that they will recover nothing if the debtor is liquidated today, Schwartz's faith in the absolute priority rule quickly fails, because the value of keeping the firm alive with the hopes of some recovery will always be more valuable to the junior creditors.[81] Moreover, taken together the junior bondholders and the trade creditors could constitute the majority in a firm. The heart of Schwartz's model—the belief that the majority will always make an efficient choice of bankruptcy systems—would therefore fail.

For example, consider a firm with $100 in senior debt, $100 in junior debt, $100 in trade debt, and equity holders. If the firm has a liquidation value of $90, the junior creditors and the trade creditors would unite to support reorganization under Schwartz's system, as it offers the only chance for these creditors to recover anything. In other words, reorganization offers these junior creditors some "option value," in that these creditors have at least some chance, however remote, of recovering on their claims in a reorganization. Because these creditors hold the majority of the firm's debt, an inefficient choice to reorganize would be made under Schwartz's

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78. Schwartz, *Bankruptcy Contracting*, *supra* note 58, at 360.

79. As discussed in section B, *infra*, intra-class creditor conflicts may also undermine Schwartz's faith that the absolute priority rule, in and of itself, will be sufficient to overcome the problem of opposing preferences with regard to liquidation or reorganization.

80. *See* LoPucki, *supra* note 58, at 328-29.

81. *See, e.g.*, R. BREALEY & S. MEYERS, PRINCIPLES OF CORPORATE FINANCE ch. 20 (6th ed. 2000).

system whenever the junior claimants expected that the proceeds of a liquidation would be insufficient to discharge the senior debt.

Professor Schwartz has also failed to account for contingent creditors in his system. While Schwartz seems to assume that, save for involuntary creditors, all creditors of a firm have current claims against the debtor, Chapter 11 debtors typically schedule a host of contingent claimants.[82] Many of these contingent creditors assert contractual claims, and cannot be dismissed as "non-parties" as Schwartz suggests. While it certainly facilitates the analysis, the division of the world between parties with currently due and owing contractual claims on the one hand, and "non-parties" on the other, incorrectly suggests that bankruptcy policy turns on a crisp choice between the steadfast protection of contractual rights and the protection of ever-so-mushy "community interests." To the contrary, executives with indemnification agreements, employees with severance agreements, parties to "requirements" contracts, parties that have signed guarantees of the debtor's obligations, employees with collective bargaining agreements, and landlords with claims for reimbursement of taxes, utilities, and the like under "triple net" leases are among the many creditors that assert contractually based contingent claims against a debtor.[83]

It is not clear what role, if any, these contingent creditors would have in a bankruptcy under this system, as Schwartz apparently assumes that non-contractual claimants are either involuntary creditors or "non-parties" asserting vague "stakeholder" interests. Contingent contractual creditors are apparently disenfranchised with respect to the choice of reorganization or liquidation under Schwartz's "majority rule" approach. The failure to address these contingent creditors also leaves serious issues unresolved with regard to the "last contract" rule for setting the optimal bribe or altering the optimal bankruptcy contract, *e.g.*,

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82. Schwartz notes that "[t]ort and environmental victims of the firm's activities do not bargain with the firm ex ante, but do have current bankruptcy claims against it. These claims should be protected in bankruptcy, but just how is beyond this Essay's scope." Schwartz, *supra* note 58, at 1810 n.15. These claims have been at the root of a host of the largest Chapter 11 cases (*e.g.*, Dow Corning, Johns-Manville, Owens Corning, A.H. Robins), and any system that fails to address litigation claims is plainly of limited utility. Until these claims are addressed, Schwartz's system, like many theoretical accounts of corporate reorganization, remains woefully inadequate.

83. Under the Bankruptcy Code these claims are subject to discharge, *see* 11 U.S.C. § 101(5) (1994), which avoids the strategic behavior that would occur if parties could convert their claim into a post-petition claim by simply fixing the debtor's liability after the filing date.

would Schwartz allow a contingent agreement to function as the "last contract" under the system?

Schwartz's scheme would also require substantial monitoring and administrative expense. For example, parties to previously drafted contracts would demand some form of notice when their agreement was "updated" to reflect the current vogue in bankruptcy terms. And, as noted earlier, a firm may need to monitor the body of contracts to determine the composition of the present majority of creditors in order to determine the firm's choice of bankruptcy systems. In short, this system requires a firm to develop a sizeable infrastructure to catalog and monitor all of the firm's contracts, from the agreements with the landscape company and the water-cooler service to the firm's indentures and revolving credit agreements. Plainly, the costs associated with such an undertaking could outstrip any inefficiencies in the current Chapter 11 system. Moreover, Schwartz's system may result in excessive vertical integration as firms attempt to "internalize" the costs associated with the contractual approach to bankruptcy.

Finally, while it is an old saw that efficiency-oriented theory assumes away its problems, it bears noting that Professor Schwartz's approach rests upon a host of simplifying assumptions that call into question the plausibility of his proposal. First, Schwartz assumes for purposes of his article that "the firm's managers represent the shareholders' interests perfectly."[84] Given that managers are vested with the power to adopt a reorganization plan that extinguishes the firm's existing equity, and managers can avoid or at least delay shareholder censure by failing to call the annual shareholders meeting,[85] this assumption seems unjustifiable.[86] It has long been assumed that managerial loyalty to

84. Schwartz, *supra* note 58, at 1825-26.

85. The failure to hold an annual shareholders meeting generally does not affect otherwise valid corporate acts. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(c) (2001); N.Y. BUS. CORP. § 602(b) (2001). *But cf.* CAL. CORP. § 600(c) (2001) (omitting relevant language). Given that shareholders meetings provide a public forum for angry shareholders to lash out at management–and that the shareholders may already be suing the management–many large corporate debtors simply ignore the requirement of holding an annual meeting. While shareholders nominally have a right to force a shareholders meeting, this right is only partially realized in reality. *See In re* Johns-Manville Corp., 66 B.R. 517, 541-42 (Bankr. S.D.N.Y. 1986).

86. Nonetheless, some version of this assumption undergirds most of the financial literature on bankruptcy. *See, e.g.*, Thomas H. Noe & Jun Wang, *Strategic Debt Restructuring*, 13 REV. FIN. STUD. 985, 988 (2000); Per Strömberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and*

shareholders cannot be taken for granted,[87] and it would seem especially odd to assume that it would flourish in Chapter 11, where officers and directors are accountable to myriad constituencies.[88] Moreover, the casual assumption of shareholder-management unity has significant consequences for Schwartz's analysis. For example, managers and shareholders may hold quite different conceptions of the optimal bribe under a renegotiation proof contract.[89]

Schwartz also assumes that the parties know, or will know after the debtor becomes insolvent, whether liquidation or reorganization is the most efficient route for a firm. This assumption is key to Schwartz's argument that the parties can contract to induce an efficient choice between liquidation or reorganization. In a fairly confusing portion of the article, Schwartz writes that

> Creditors can prove in court how much money the firm earned while in the bankruptcy system it chose (bankruptcy returns are "verifiable"), and the parties can observe the circumstances that exist ex post. Thus parties know after insolvency which of the two bankruptcy systems would maximize monetary returns.[90]

Schwartz's conclusion does not follow from his premise: once the firm has earned any amount under a particular bankruptcy system, it is too late to make a choice among bankruptcy systems.[91] The choice then must be made at the point of default (or insolvency in Schwartz's parlance). Before the start of any particular procedure, however, there is no reason to believe that even the most sophisticated of creditors, or debtor's management, can make an

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Tests, 55 J. FIN. 2641, 2643 (2000).

87. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

88. *See* William C. Whitford, *What's Right About Chapter 11*, 72 WASH. U. L.Q. 1379, 1384 (1994).

89. Moreover, the failure to distinguish between management and the firm leads to illogical results and confusion in Schwartz's theory. For example, Schwartz repeatedly states that "the firm also wants to consume private benefits," Schwartz, *supra* note 58, at 1827, surely a bizarre concept if taken literally, and an impossibility with respect to the shareholders of most publicly held corporations.

90. *Id.* at 1823.

91. Schwartz's attempt to deflect Professor LoPucki's criticism of his handling of the problem of conflicting creditor interests suffers from a similar temporal problem. *See* Schwartz, *Bankruptcy Contracting, supra* note 58, at 353. In his model, Schwartz seems to assume that the choice between liquidation and reorganization takes place simultaneously with a firm's liquidation or reorganization. Of course, the choice among systems generally must be made, and a process engaged, before the creditor has an opportunity to compare recoveries under reorganization or liquidation.

unbiased and accurate prediction of the variables that can influence the course of a bankruptcy case.[92]

Of course, once a firm has chosen a path, it is easy to engage in counterfactual theorizing about what might have been, but such an exercise is of little value once a choice to either reorganize or liquidate has been made. The majority of creditors are likely to simply vote their parochial interests when it comes time to implement Schwartz's "majority rule" approach. It can be expected that senior creditors will favor liquidation regardless of larger questions of efficiency. Management may be unable to make an efficient choice under a renegotiation-proof agreement, despite its best efforts, and ingrained managerial optimism may take hold and result in the inevitable choice to reorganize.

Finally, the most obvious, yet critical assumption undergirding this theory is Schwartz's belief that a system producing more liquidations would be inherently more efficient. Over twenty years after the enactment of the Bankruptcy Code, however, the relative efficiency of liquidation versus reorganization remains a mystery. While Schwartz can point to several potential inefficiencies of reorganization, absent empirical data, and a grounding in the realities of Chapter 11 as practiced, it is impossible to know if these are true problems, and how the inefficiencies Schwartz identifies compare to the costs of a comparable liquidation.[93] Since the formal liquidation of large publicly held companies under Chapter 7 remains a rarity, it is impossible to know if this reality reflects managerial abuse of Chapter 11, as Schwartz suggests, or a belief among market participants that Chapter 11 is an optimal system, even for liquidation.[94] Since anecdotal evidence about any serious attempts to convert large cases to Chapter 7 is lacking, Professor Schwartz and other proponents of more frequent liquidation bear at least some obligation to demonstrate why it should not be

92. The problem is compounded in Schwartz's system, as the parties must contract for their desired system at a point in time before the firm even faces a choice among bankruptcy systems. *See* LoPucki, *supra* note 58, at 373.

93. These liquidation costs include not only the loss in going concern value, but also the costs associated with individualized collection efforts, if the liquidation is accomplished under state law. *See* Elizabeth Warren, *Untenable Case*, *supra* note 6, at 468 n.136.

94. Liquidations of large corporations are typically accomplished by way of a Chapter 11 liquidating plan, which may follow the sale of a company's assets under 11 U.S.C. § 363(b). Recent examples include the liquidations of Vlasic Foods International, Inc., Brazos Sportswear, Inc., and Mid-American Waste Systems, Inc. following the sale of most the debtors' operating assets.

assumed that the market has already decided in favor of reorganization.

Professor Schwartz's system leaves us with the impression that it is more than a few steps removed from practical application. While the overall intellectual structure of the theory is intriguing, broad swaths of practical detail remain unaddressed. What is more, the reliance on the unproven belief that "liquidations are better" suggests that the theory remains tethered to the unanswered, and perhaps unanswerable questions that have plagued Chapter 11 theory since its early days.

C. Barry E. Adler, "A Theory of Corporate Insolvency"[95]

Professor Adler's approach to bankruptcy reform envisions an entirely new way of financing corporations. Under the Chameleon Equity approach, he proposes that firms would replace their current debt and equity financing with a series of levels of preferred stock. Upon a default, the lowest level of stock would be automatically canceled, and the next lowest level of stock would effectively become the existing common shareholders of the firm. Parties could structure this system in a way that would only allow firms with little or no "going concern" value to enter bankruptcy, indicating that a firm that actually enters bankruptcy under his system should be liquidated.[96] According to Professor Adler, "automatic conversion of the lowest-priority fixed-obligation class to common equity, and the survival of higher-priority classes, would accomplish a reorganization of an insolvent firm without the expensive imbroglio that is often a consequence of the current bankruptcy reorganization process."[97] Adler concedes that corporations have failed to adopt anything resembling his Chameleon Equity structure "in part because tax, tort, commercial, and corporate laws create legal impediments to such adoption."[98] As Warren and Westbrook have noted, these practical impediments are themselves indications of the theory's viability.[99]

95. Adler, *supra* note 2. This article builds on the system first proposed in Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993).

96. Adler, *supra* note 2, at 367.

97. *Id.* at 353.

98. *Id.* at 377.

99. Warren & Westbrook, *supra* note 11, at 1287. The Tax Code modifications that Professor Adler's approach would require have been the subject of much debate and little actual legislative action for decades. *See generally* Katherine

More importantly, even absent appreciable legal hurdles, it remains doubtful that any firm would actually finance its operations through the Chameleon Equity structure. In the first instance, Adler's approach will only work if firms implement a "cash and carry" approach to their dealings with trade creditors, as the system makes no room for a fluid mass of trade debt.[100] Additionally, a firm would have to accurately predict all of its future liquidity needs at the time of a preferred stock offering. Indeed, to the extent there are significant economies of scale with respect to securities offerings, a firm would be well advised to aggregate its trips to the financing market, and would have to anticipate liquidity needs very far in advance.[101]

Failing such foresight, short-term liquidity problems would either compel the draconian solution of canceling equity or the cost of a new offering. There is no room for a revolving credit line in this system. Moreover, the need to accumulate cash may itself have destructive consequences, from a corporate governance perspective, that outweighs any benefits obtained in reducing the costs of financial distress.[102] The liquidity problems associated with the Chameleon Equity system may also induce a return to conglomerate structures, surely a retrograde development in this day and age.

Professor Adler's system also involves substantial monitoring expense. Absent a comprehensive, and presumably legislatively enacted, ban on corporate debt, preferred shareholders would have to maintain a constant vigil against the creation of debt, which

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Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055 (2000). Presumably comparable modifications to the relevant tort, commercial, and corporate laws would be no easier to achieve.

100. The firm would literally have to pay its trade creditors and employees in cash, as every unpaid check makes the holder a creditor of the firm.

101. It is conventional wisdom that there are economies of scale in underwriting fees, *see, e.g.*, Inmoo Lee, et al., *The Costs of Raising Capital*, 19 J. FIN. RES. 59 (1996), but a recent article argues that underwriting spreads may actually move in relation to issuer quality without regard to the size of the offering. Oya Altmkihç & Robert S. Hansen, *Are There Economies of Scale in Underwriting Fees? Evidence of Rising External Financing Costs*, 13 REV. OF FIN. STUD. 191 (2000).

102. *See* Tom Nohel & Vefa Tarhan, *Share Repurchases and Firm Performance: New Evidence on the Agency Costs of Free Cash Flow*, 49 J. FIN. ECON. 187 (1998) (concluding that the positive investor reaction to repurchases represents the perceived value of eliminating management control over liquid assets); *see also* James F. Cotter & Sarah W. Peck, *The Structure of Debt and Active Equity Investors: The Case of the Buyout Specialist* 59 J. FIN ECON. 101 (2001) (finding that using more senior debt significantly increases the performance of post-LBO firms).

would obtain a senior priority in the debtor's capital structure. Given the multitude of ways a claim against a firm can come into existence, this monitoring would be problematic. Covenants between the preferred shareholders and the debtor-firm would provide some protection, but a breach of contract claim against an insolvent firm is of little value at the end of the day.

In sum, the Chameleon Equity structure sacrifices a good deal of financing adaptability for the sake of an event that most firms will never know. The respective benefits offered by capital leases, secured debt, straight debt, subordinated debt, convertible debt, preferred stock, and common stock simply cannot be replicated by an array of preferred stock, no matter what the bankruptcy gains.

III. A General Critique of Current Chapter 11 Theory

The Bebchuk, Schwartz, and Adler articles represent the core of a larger body of Chapter 11 theory, the majority of which is hostile to Chapter 11 as currently constituted. Four general problems underlie this body of work and explain the failure of reorganization theory. First, the authors of these theories rarely acknowledge the complex ownership and capital structures at issue in large Chapter 11 cases, or the reasons for these structures. Second, these theorists have no more than a superficial understanding of Chapter 11. Closely related to this second point, the authors of these theories also fail to demonstrate, other than by mere declaration, that their favored system would result in any significant efficiency gains. Finally, the authors of these theories never explain how theories developed within abstract models can be connected to a practical model that even resembles the proffered theory.

A. Corporate Complexity and Simple Models

In the view of the typical academic, the run-of-the-mill corporate debtor is a large, publicly traded firm, with an exceedingly simple capital structure. Ideally, the firm will have no employees, trade creditors, litigation claimants, obligations to governmental authorities, or contingent claims. The closest real world equivalent to the academic model would be a simple holding company—with one or two tranches of bondholder debt and one

class of publicly held common stock—which continues to be listed on a national exchange even after the debtor files for bankruptcy.[103]

The model firm is at the same time too large, and too simple. Thirty-eight public firms with assets of more than $500 million filed for Chapter 11 relief in 2000, only four of which had assets of more than $5 billion.[104] In 1999, there were thirty Chapter 11 cases involving public companies with assets of more than $500 million.[105] Thus, the firms that are modeled are truly unique, representing the largest of the cases handled by five or six leading law firms in two or three major cities in the country.

More importantly, the large firms that do file for Chapter 11 relief rarely have the austere capital structures that most academic models take for granted. And even firms with simple balance sheets may have complex capital structures, especially when existent and expected litigation claims, priority disputes, inter-company claims, and collateral valuation issues are thrown into the mix.

The reasons for the complexity found in large corporate debtors is in part a result of the "tax, tort, commercial, and corporate laws" that Professor Adler seeks to repeal.[106] But financial structures in troubled companies also echo past corporate acquisitions that resulted in the assumption of the financial structures of several smaller companies. They also reflect certain legacy effects, in as much as certain transactions–e.g., equipment purchases–have almost always been financed in particular ways, and companies find cost saving in following previously established forms.

Financial structures also reflect the partitioning of a firm's assets among creditors. Just as the creation of the firm itself reflects, among other things, an attempt to define a set of assets

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103. Many companies that file for relief under Chapter 11 have, in fact, been delisted by an exchange. One author found that only 20% of the *public* firms that filed for Chapter 11 between 1986 and 1993 were listed on an exchange. Brian L. Betker, *The Administrative Costs of Debt Restructurings: Some Recent Evidence*, FIN. MGMT. 26, 58 (1997). The author did not report what portions of the 80% of unlisted firms were delisted, and what portion had never been listed.

104. Owens Corning was the largest, with assets of almost $6.5 billion. All figures are taken from data complied by New Generation Research, Inc., *available at* http:\\www.bankruptcydata.com.

105. ARM Financial Group, Inc., with assets of more than $9 billion, was the largest public company to file in 1999. No other company had assets of more than $5 billion.

106. Adler, *supra* note 2, at 377.

associated with an enterprise,[107] a firm partitions itself throughout its life in an attempt to meet liquidity and capital needs. Thus, the firm's equipment may be pledged to equipment vendors, inventory and receivables to banks, and fixed assets to bondholders. The liquidity problems that often precede a bankruptcy filing may induce management to seek new sources of funding through this partitioning process, thus rendering the firm's capital structure even more complex. The result is a firm that has been partitioned among creditors, and yet also remains liable as a whole to a larger group of completely unsecured creditors.

Accordingly, a more realistic model would start with a secured bank line, issued to the parent company and guaranteed by the subsidiaries, often secured by the operating assets of the subsidiaries and the parent company's stock in the subsidiaries, which would likely be further subdivided between term loans, revolving credit facilities, and a line for writing letters of credit. The loan would either be held by a group of banks, or, as is becoming more common, the loan would be a leverage loan facility.[108] In either case, the loan can be divided into various tranches, each of which may have a differing priority against the debtor.[109]

The parent company will also have issued at least one layer of publicly held debt, which again may be guaranteed by the subsidiaries. The operating companies will have a variety of trade creditors, who are typically *pari passu* with the public debt, and the guarantees of that debt. The trade debt will itself be variegated, based upon the size and sophistication of the trade creditor in question. General Electric or Minnesota Mining and Manufacturing can wait for payment of a one million dollar pre-petition debt, but a more modestly sized trade creditor may face financial

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

108. *Cf.* Edward I. Altman & Heather J. Suggit, *Default Rates in the Syndicated Bank Loan Market: A Mortality Analysis*, 24 J. Bank. & Fin. 229, 236 (2000).

109. For example, during the relatively brief period between its first and second Chapter 11 case, Bradlees Stores, Inc. entered into a working capital facility that consisted of three tranches. Tranche A consisted of a $250 million senior-secured revolving line of credit, of which $90 million was available for letters of credit. Like Tranche A, Tranche B was secured by the debtor's non-real estate assets, and consisted of a $20 million junior secured credit facility. Tranche C consisted of a $20 million credit facility, secured by second liens on the debtor's non-real estate assets and a first lien on certain leasehold assets.

problems themselves if an anticipated receivable is suddenly withheld.

Landlords are also of equal priority with the trade creditors, but are subject to the Bankruptcy Code's system that allows debtors to assume or reject executory contracts and unexpired leases. If a lease is assumed, the landlord must be paid in full. If the lease is rejected, the landlord becomes a pre-petition creditor, even though the landlord's claim for breach of the lease may arise years after the debtor first entered bankruptcy court. In a very large case, or in a retail bankruptcy, a debtor may have hundreds of real property leases. While the unique nature of leases may be a consequence of the Bankruptcy Code as currently drafted, distinguishing landlords from the mass of creditors also acknowledges the fact that many landlords, save for large REITs, are relatively unsophisticated, especially in comparison to other creditors with similar size claims.

The other major constituencies to be considered include utility companies, employees, equipment lessors, and shareholders. Unless the model takes into account these major parties to any reorganization, at least in the later variants of the model, the true complexity of the conflicts in bankruptcy will never be captured. While it is possible to model a bankruptcy system that assumes that firms will make any needed change to its capital structure to conform to the bankruptcy scheme, this assumption is hardly plausible. Like building a bomb shelter in your backyard, radically changing a firm's capital structure to accommodate a future Chapter 11 filing is an expensive undertaking that guards against a remote possibility. Few large firms ever experience Chapter 11, and probably even more firms assume that they will never enter Chapter 11.

B. *Misunderstanding Reorganization (Myths About Chapter 11)*

One can read a good deal of Chapter 11 theory and criticism without ever stumbling upon a clear explanation of what Chapter 11 entails. Aside from vague utterances about "negotiated bargaining," most authors do not feel the need to define the target of their attacks.[110]

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110. *See, e.g.*, Barry E. Adler, *The Emergence of Markets in Chapter 11: A Small Step on North LaSalle Street*, 8 S. Ct. Econ. Rev. 1 (2000); Bebchuk, *Using Options*, *supra* note 24, at 831; Oliver Hart et al., *A New Bankruptcy Procedure that Uses Multiple Auctions*, 41 Eur. Econ. Rev. 461, 463 (1997).

When Chapter 11 is defined, it often appears in the most superficial of ways.[111] These explanation of Chapter 11 are in general not patently wrong, but they reflect a hornbook understanding of the process, which often differs from reality.

1. Reorganization According to Theory—One of the most paradoxical aspects of many efficiency-based theories of reorganization is that these theories rarely offer the debtor any real opportunity to reorganize. Efficiency theorists have almost uniformly authored theories of "reorganization" that depend on either the quick sale or liquidation of a company. Save for any reorganization of the debtor under a new owner, these proposals are not concerned with reorganization, and bankruptcy is merely a form of debt collection.[112] Given that these authors typically have no basis for assuming that it will be practical to sell a Chapter 11 debtor as a going concern, many of these theories ultimately boil down to proposals to liquidate the debtor.[113] If a firm is in a declining industry with excess capacity, the gains from quickly redeploying assets through a sale—if a sale is even realistic—will be relatively small, or non-existent.[114] Even if a firm is in a healthy market segment, steadfast requirements that any sale occur within an expedited and bounded time frame will likely result in "low-ball" offers for the debtor.[115] Similarly, blindly exchanging debt for equity, or otherwise "automating" the process, does not represent a sincere reorganization of a troubled company, and likely amounts to nothing more than a postponement of the firm's problems.

The view of reorganization and liquidation that informs these theories also assumes a clean divide between the two bankruptcy functions.[116] In point of fact, Chapter 11 is often used to "partially

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111. *See, e.g.*, Philippe Aghion et al., *Interdisciplinary Conference on Bankruptcy & Insolvency Theory: Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 857 (1994).

112. Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 n.3 (1987) (viewing bankruptcy as an alternative method of debt collection that should adhere to non-bankruptcy substantive rights).

113. In these cases, the appropriate frame of reference may not be Chapter 11 but Chapter 7.

114. *See* Vojislav Maksimovic & Gordon Phillips, *Asset Efficiency and Reallocation Decisions of Bankruptcy Firms*, 53 J. FIN. 1495 (1998).

115. *See* Todd C. Pulvino, *Effects of Bankruptcy Court Protection on Asset Sales*, 52 J. FIN. ECON. 151, 154 (1999) (arguing that the bankruptcy status, even under the current system, encourages "low ball" offers by opportunistic bidders).

116. Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 68-69 (1992).

liquidate" a business that has over-extended itself.[117] Be it through the rejection of unprofitable operating leases, or the sale of ill-advised acquisitions, Chapter 11 works as a vehicle for unwinding, and often liquidating, the unprofitable portion of a business. Although in theory the new owner of a firm could accomplish this same sort of restructuring post-auction, Chapter 11 provides a convenient way to partition a firm's operations in a single, comprehensive transaction. In the process, however, Chapter 11 serves a function that transcends the simple "hypothetical sale" approach to reorganization that appears in many academic papers.

On the other hand, the curious view of "reorganization" that permeates many theoretical discussions of Chapter 11 works well with the highly atypical companies that populate these models.

2. *The Myth of Shareholder Activism*—As touched on in the discussion of Professor Schwartz's approach to reorganization, it is a common theoretical move to conflate management and equity, thereby avoiding the complications of the tripartite debtor-creditor-shareholder conflict that pervades corporate reorganization.[118] It is also often stated in theoretical conceptions of Chapter 11 that, because firms tend to prefer to confirm a consensual plan, shareholders are in a position to extract rents from more senior creditors.[119] Given the relative ease with which a plan can be

117. Examples of this can be seen in any of the recent retail Chapter 11 cases in which the debtor has often closed multiple unprofitable locations. The cap on lease rejection damages contained in 11 U.S.C. § 502(b)(6) (1994) makes Chapter 11 an especially attractive vehicle for shrinking the retail firm that has grown too fast.

118. For example, Richard Posner explains that under Chapter 11:

> [M]anagement is allowed to continue operating the corporation as debtor in possession; there is no trustee, and no steps are taken to liquidate the firm. But the corporation must come up with a plan of reorganization within six months, whereby the firm will continue in operation but with a different ownership structure. The plan will propose converting the debt of the corporation into stock and other securities to be assigned to the creditors in payment of the corporation's debt to them, so that the creditors will become the corporation's owners (or principal owners, because often the original shareholders assign themselves some part of the stock).

RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 443-44 (5th ed. 1998). Note the subtle move from "management" to "the corporation," to "original shareholders." *See also* Lucian Ayre Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445 (2002) (forthcoming, draft *available at http://ww.afajof.org/Pdf/feb_02/Bebchuk.PDF)*.

119. *See, e.g.,* Bebchuk, *Chapter 11*, *supra* note 24.

"crammed down" on equity, this proposition seems plainly unsupportable.[120]

For the most part, shareholders play little, if any, role in a Chapter 11 case. Indeed, the few recently reported cases of shareholder activism in large Chapter 11 cases concerned either the relatively exceptional case of firms filing for Chapter 11 relief to avoid mass tort liability, or instances in which a class of creditors has obtained a controlling block of equity.[121] In the first case, the firm is likely solvent (but for the potential litigation claims) and shareholders have a strong interest in seeing that management does not enter into an overly generous settlement agreement with the litigants. In the second, the "shareholders" are plainly advancing their interests as creditors.

Equity is commonly canceled in Chapter 11 plans, and new equity issued to creditors.[122] Shareholders therefore have little incentive to sink further funds, in the form of hiring bankruptcy counsel to contest the plan, into their already unprofitable investment as it is quite probable that they will receive nothing under the plan in any event. Moreover, unless a firm enters bankruptcy as a result of a sudden financial shock, shareholders

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120. Under 11 U.S.C. § 1129(b)(2)(C)(ii) (1994), a plan can be crammed down over the dissent of a class of interests (*i.e.*, equity) if no junior class will receive any recovery under the plan. Given that this is almost universally the case with respect to equity, achieving this form of cram down is quite undemanding. Early studies of Chapter 11 often found absolute priority violations in favor of equity, but anecdotal evidence suggests that these studies may no longer reflect current practice. *See infra* note 81.

121. *See In re* Johns-Manville Corp. v. Equity Sec. Holders Comm., 801 F.2d 60 (2d Cir. 1986); *In re* Marvel Entertainment Group. v. Chase Manhattan Bank (*In re* Marvel Entertainment Group), 209 B.R. 832 (D. Del. 1997).

122. A search (conducted on December 13, 2001) of the Bankruptcy DataSource files on LEXIS revealed that in the previous 12 months alone, the following companies proposed plans which provided for no distribution to equity: Coram Healthcare Corporation; Hechinger Company; Loewen Group International, Inc.; Vlasic Foods International, Inc.; American ECO Holding Corp.; Applied Magnetics Corporation; Bradlees Stores, Inc.; Cambridge Industries, Inc.; Stellex Technologies, Inc.; Kitty Hawk, Inc.; Oldgen, Inc.; Mediq, Inc.; MicroAge, Inc.; Stage Stores, Inc.; DeVliegh-Bullard, Inc.; Hedstrom Holdings, Inc.; LaRoche Industries, Inc.; Vista Eyecare, Inc.; AgriBioTech, Inc.; Master Graphics, Inc.; Complete Management, Inc.; Fruit of the Loom, Inc.; Medical Resources, Inc.; Laclede Steel Company; and Prime Succession, Inc. Several other firms proposed plans that resulted in significant dilutions of equity. For example, American Banknote Corporation shareholders received 7.7% of the new equity in the reorganized company. *Accord* Allan C. Eberhart et al., *The Equity Performance of Firms Emerging from Bankruptcy*, 54 J. FIN. 1855, 1855 (1999) ("When firms emerge from bankruptcy, they often cancel the old stock and distribute an entirely new issue of common stock.").

likely have witnessed a long-running decline in the firm's share price, prompting many shareholders to sell out before the bankruptcy case. The group of shareholders that continue to hold their shares after the filing is thus likely to be heavily weighted in favor of inattentive, and inactive shareholders, combined with a group of disappointed optimists.[123]

Management is therefore likely to shift its attention to creditors, who may soon become the firm's new shareholders. Indeed, it is not difficult to find instances where shareholders write to the bankruptcy court, or bankruptcy counsel, to complain that they are being ignored by current management.[124] In some cases, where shareholders continue to maintain some interest in the firm, the United States Trustee will appoint an "equity securities holders committee," which allows shareholders to present a united front to management.[125] The need for such a committee, however, underscores the dubious nature of the assumption that management can generally be viewed as subservient to equity in Chapter 11 cases.[126] In addition, when debts become aggregated in a few hands—most often as the result of claims trading—creditors exercise significant disciplinary power over management, which assures that management will resist the temptation to favor their former masters.[127] The contention that shareholders can use Chapter 11 to extract rents from a distressed corporation is thus unpersuasive.

3. *The Importance of the Trade Creditors*—The trade creditor—be they vendor or customer—is one of the most neglected and misunderstood parties in Chapter 11 theory. Often trade creditors are ignored by theorists altogether, or reduced to a

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123. A fair amount of small investors apparently make investment decisions based upon faulty notions of Chapter 11. *See* Gretchen Morgenson, *Market Watch: Shaky Concerns Are the Talk of Chat Rooms*, N.Y. TIMES, Jan. 23, 2000, § 3, at 1.

124. *See, e.g.,* Letter dated October 24, 1994 from shareholder of Cambridge Biotech Corporation to bankruptcy court official. *In re* Cambridge Biotech Corp., 94-43054 (JFQ) (Bankr. D. Mass. Oct. 24, 1994) (on file with author). In the letter, the shareholder asks "[d]oesn't Cambridge Biotech, even though it is in Chapter 11 Bankruptcy have a duty to inform common stock shareholders what is going on?" *Id.*

125. *See* 11 U.S.C. § 1102 (1994). Such a committee was eventually appointed in the Cambridge Biotech Corp. case.

126. *Cf.* United States Trustee v. Official Comm. of Equity Sec. Holders Crimi Mae Inc.), 247 B.R. 146, 152 (D. Md. 1999) (noting that bankruptcy court had "found that a committee of equity security holders would be beneficial to the reorganization process by ensuring that these investors will have a voice in the plan formulation and confirmation process.").

127. *See* Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 402-03 (1997).

faceless class of junior creditors in hypotheticals. When trade creditors are addressed, they are often seen as co-conspirators in the perpetuation of broken firms. While Professor Adler calls for the abolition of trade debt, and Professor Schwartz calls for the disenfranchisement of these creditors, trade debt actually plays a vital role both *ex ante* and *ex post* in the financing of a firm.

Ex ante, the presence of trade debt signals that unsecured creditors are willing to deal with the company, and conveys important information to potential investors, who may have less insight into the debtor's day-to-day operations. If a trade creditor is unwilling to extend credit to a firm for thirty or sixty days, an investor may rightly wonder if it would be prudent to extend credit to the same firm for ten or more years. A tightening of trade credit is often the first public signal of a firm's financial trouble. Absent the information conveyed by the presence of trade debt, investors might incur additional expenses gathering information about the firm, expenses which would ultimately raise the costs of debt financing, in violation of a basic tenet held by most, if not all, of the efficiency-minded critics of Chapter 11.

Ex post (*i.e.*, following a Chapter 11 filing) trade creditors take on an import that exceeds the face value of their claims, as many such creditors have the ability to halt a debtor's operations by halting deliveries. Contrary to the common belief that trade creditors are the most junior players in a Chapter 11 case, save for equity, some trade creditors come to the bankruptcy case with state-law mechanics and possessory liens in the debtor's goods and projects. Even those trade creditors that are contractually bound to continue serving the debtor may have leverage over the debtor if they provide services beyond what is contractually mandated. For example, the shipping company that is obligated to provide six trucks a day to the debtor's plant may discontinue its prior practice of providing seven trucks when the debtor's output warrants this additional capacity.

Thus, debtor's will often seek to pay certain trade creditors as "critical vendors."[128] Plainly, these payments violate the absolute

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128. Recent examples of this practice can be seen in, *In re* Trans World Airlines, Inc., Case No. 01-0056 (SLR) (D. Del. Jan. 27, 2001) (approving payments of up to $9.8 million in pre-petition trade vendor claims); *In re* Owens Corning, Case No. 00-03837 (MFW) (Bankr. D. Del. Oct. 6, 2000) (approving payment of pre-petition "critical" trade vendors claims); *In re* Philip Servs. (Delaware), Inc., Case No. 99-02385 (MFW) (Bankr. D. Del. June 28, 1999) (authorizing payment of up to $15 million in claims of critical vendors and

priority rule, to the extent that they allow a select group of unsecured creditors to recover more than they would recover in a liquidation, yet it is hard to envision any system of reorganization functioning without a means to ensure the cooperation of at least a core group of the debtor's suppliers. Even those systems that call for auction of the debtor shortly after the bankruptcy filing might require the payment of "critical vendors" to ensure that the debtor's going concern value was not destroyed pending the outcome of the auction.

Accordingly, when it comes time to vote on a plan, the debtor's trade creditors may not be the docile group of junior creditors that is often depicted in bankruptcy theory. Indeed, those vendors that would have been most likely to side with the debtor may have been removed from the class by way of critical vendor payments. Many remaining vendors will harbor ill will towards the debtor, having been told that they are not "critical vendors" entitled to early payment.

Other vendors will themselves have experienced financial distress, if not bankruptcy, as a result of the delay in payment of a claim that may have represented a large portion of the vendor's income for the year. Some creditors will step to the front of the line, asserting secured claims as a result of their state law liens, although many of these creditors will also have been paid during the course of the case as a consequence of the debtor's need for the goods that were subject to the lien.[129] Finally, many trade creditors will have sold their claims to "vulture" investors, who represent some of the most active participants in a bankruptcy case. Thus the class of trade creditors often contradicts the picture painted by Professor Schwartz and others of a group committed to the preservation of the debtor, regardless of the long-term efficiency consequences of such a course of action.

As any practitioner can attest, the early days of a large Chapter 11 case involve intense negotiations with vendors and customers who often react to news of a Chapter 11 filing in ways that seem to be patently against their long-term interests: railroads halt boxcars, service firms pull their employees from the debtor's plants, suppliers call to assert reclamation rights under the U.C.C., all

suppliers with ongoing relationships with the debtors).

129. *See, e.g.*, *In re* VF Brands, Inc., Case No. 01-00285 (SLR) (D. Del. Jan. 29, 2001); *In re* Eagle Food Centers, Inc., Case No. 00-01311 (ARM) (D. Del. Mar. 2, 2000).

despite the prospect that future business with the debtor might be more valuable than any losses the creditor might suffer on their pre-petition claim. If the debtor's business is to continue, these concerns must be addressed.

That existing Chapter 11 theory could neglect trade creditors in the face of their manifest importance is but the most clear example of how these theories are disconnected from the financial and operational realities of the typical Chapter 11 debtor. Theorists that impair or otherwise undermine the role of trade creditors have a duty to explain why this move would not result in significant increases in the *ex ante* costs of debt financing for all firms, as a result of the loss of the information conveyed by trade debt.

4. The Myth of the Duped Creditor—Current Chapter 11 theory has adopted somewhat conflicting contentions: the costs of Chapter 11 are said to be born by all borrowers *ex ante*, and a debtor's lenders *ex post*. Thus, critics of Chapter 11 often complain that Chapter 11 increases the costs of borrowing through increased interest rates and the like, and imposes significant costs on lenders through delay and reduced recoveries.

Plainly, however, if the borrowers have already paid for the expense of Chapter 11, it is not quite accurate to state that creditors are incurring costs *ex post*. In Chapter 11, a lender is simply forced to realize a cost that the borrower paid for long ago. To be sure, if lenders systematically underestimated the costs of Chapter 11 this would not hold, but it is hard to believe that lenders would be able to survive in the market if they were making such errors. Moreover, since the Bankruptcy Code has now been in operation for over twenty years, lenders, at least sophisticated lenders, should be in a position to anticipate and price the costs of Chapter 11, whatever they may be. After the disastrous Eastern Airlines case, it would be hard to suggest that lenders are unaware of the potential "worst case scenarios" that could develop in Chapter 11.[130]

Even if the issue is phrased as one of "efficiency," it is not at all clear that the mere presence of costs equates with inefficiency, at least from the perspective of the firm and its lenders. Indeed, what may be *ex ante* efficient for the firm, or its management, might be

130. *In re* Ionosphere Clubs, Inc., 113 B.R. 164 (Bankr. S.D.N.Y. 1990); *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).

highly inefficient from a social perspective and visa-versa. For example, while it is a fundamental tenet of finance theory that, *ex ante*, lenders and shareholders will want to limit the firm's *ex post* flexibility and thereby reduce *ex ante* borrowing costs, the borrower's management is in fact likely to seek as much *ex post* flexibility as practicable, passing the cost of this flexibility on to the shareholders. While it might be more efficient for society as a whole to discourage lending arrangements of this sort, as all firms may pay some small amount for a particular firm's investment in reorganizational flexibility, ultimately the borrower and lender will have little incentive to take these considerations into account if their private interests lie elsewhere.[131]

The point being that costs imposed upon lenders during the pendency of a Chapter 11 case are largely irrelevant if these costs have already been recovered from the borrower. Merely bemoaning the presences of "costs" is thus unhelpful; at best these costs are likely nothing more than a familiar deadweight cost of the separation of ownership and control in a firm. Of course such costs will be of concern to the borrower *ex ante*, and may raise concerns of societal efficiency, but there is no reason to lament the mere presence of costs *ex post* unless such costs were entirely unforeseeable.[132]

C. Is Chapter 11 Really Inefficient?

1. The Costs of Chapter 11—Much of the efficiency-based literature on Chapter 11 finds its foundation in the claim that Chapter 11 imposes significant *ex ante* and *ex post* costs on creditors and on borrowers in the capital markets.[133] Lenders incur costs when their contractual rights are not respected under Chapter 11 and when their recoveries are diminished by a long and costly Chapter 11 process. Borrowers incur costs when they are forced, *ex ante*, to bear the costs of Chapter 11 through higher costs of capital.

The costs of Chapter 11, although widely believed by academics to be quite substantial, have been difficult to unearth.

131. *Cf.* Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. L. STUDIES 575 (1997).

132. Such unforeseeable costs are, in point of fact, nothing more than a variant of the retroactivity problem that has been the obsession of western jurisprudence for at least the last fifty years. *See, e.g.*, LON L. FULLER, THE MORALITY OF LAW (2d ed. 1969).

133. *See, e.g.*, Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy*, 3 AM. BANKR. INST. L. REV. 85, 90 (1995).

Empirical studies have found that the direct costs of Chapter 11–chiefly the professional fees incurred–are quite modest, and are actually lower than those incurred in other significant corporate transactions.[134] Another study has found that firms that experience financial, as opposed to economic, distress incur the bulk of the costs of such distress in the period before filing for Chapter 11.[135] While it is easy to point to the myriad troubles experienced by firms in Chapter 11–increased employee turnover, managerial distraction, vendor difficulties, loss of business reputation, higher debt costs and the like–it seems likely that these indirect costs would be associated with financial or economic distress generally, irrespective of the nature of Chapter 11.

That the critics of Chapter 11 have not proved that Chapter 11 is excessively expensive is, however, only half of the matter. A close look at the potential costs of the proposed replacements for Chapter 11 is also warranted. Plainly, the costs of reorganization cannot be reduced to zero, and it also does not represent a true reduction in costs if expenses are simply shifted in time. The spread between the total costs of Chapter 11, as currently constituted, and the total costs under a hypothetical reform proposal is the key issue, but virtually the whole of Chapter 11 theory neglects to even attempt any such analysis. As noted with regard to the articles critiqued in section II, however, many current Chapter 11 reform proposals would appear to entail significant costs, and it is in question whether these costs might not outstrip the costs of the current Chapter 11.[136] Further, there is at least some possibility that liquidations or auctions of firms might ultimately result in just as many absolute priority violations as reorganization, notwithstanding formal compliance with priority rules.[137] At the very least, the authors that would repeal Chapter 11 in place of some ostensibly superior system have some obligation to demonstrate

134. 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 (2000); *see also* Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990).

135. Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence From Highly Leveraged Transactions That Became Distressed,* 53 J. FIN. 1143 (1998).

136. *See* Lubben, *The Direct Costs of Corporate Reorganization*, *supra* note 134, at 548-50.

137. Per Strömberg, *supra* note 86, at 2645 (arguing that owner/mangers and senior lenders may conspire to deflate the sale value of auctioned firms, to the determent of mid-level claimants).

exactly how their approach would result in any significant efficiency gains.

2. *Is Chapter 11 Really Inefficient?*—Chapter 11's stated inefficiency is, of course, the keystone of much of the literature on this subject. The common claim is that violations of the absolute priority rule undermine *ex ante* contractual expectations, leading to an eventual increase in the costs of capital, or even reducing the availability of capital.[138] Given the few large firms that ultimately file for Chapter 11 relief and the modest nature of the absolute priority violations that do occur, the expected *ex ante* costs of Chapter 11's failure to adhere to a strict absolute priority rule should be quite modest.[139] Moreover, some creditors may have the ability to impose these costs solely on defaulting borrowers, thereby further reducing the *ex ante* costs to borrowers in general.[140]

In short, the *ex ante* costs that theorists have attacked with much vigor may be quite small. As with the direct costs of Chapter 11, *supra*, this raises the question of how the societal inefficiencies of Chapter 11 fair in comparison to the putative efficiency gains under the competing, theoretical forms of corporate reorganization. Even assuming that all asserted efficiency gains are realized, the potential for offsetting losses–such as would occur if viable firms were needlessly liquidated–also presents the question of whether the gains under the reforms are significant. These are, at present, questions without answers, but they do highlight the failure of many theorists to even address these issues. The connection between the theoretical model and the larger world is once again lacking.

3. *The Overlooked Facet of Creditor Conflicts*—It is widely recognized that junior and senior claimants have divergent interests upon the onset of financial distress. A rarely recognized problem is the frequency of intra-class creditor conflicts, a problem that goes beyond mere differing risk tolerances or preferences.

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138. Philippe Aghion et al., *supra* note 111, at 853.

139. 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) (finding that these violations rarely exceeded 10% of the value of the total distribution to unsecured creditors). Note that LoPucki and Whitford's figures reflect the early years of the new Bankruptcy Code. In more recent times, anecdotal evidence suggests that existing equity is often canceled as part of a Chapter 11 plan. *See supra*, note 122.

140. For example, a recent theoretical article proposes that banks do not price default in initial lending arrangements, leaving these terms to be negotiated on an "as needed" basis when the borrower encounters financial difficulties. *See* Gary Gorton & James Kahn, *The Design of Bank Loan Contracts*, 13 REV. OF FIN. STUD. 331 (2000).

Consider a firm that issues public debentures. At the time of the issue, the firm's debt may be classed as investment grade. Several mutual funds, insurance companies, and other institutions purchase the issue, but a host of individuals also purchase small portions of the offering. As the issuing firm's prospects fade, and the firm becomes a "fallen angel," the original institutional holders will sell their debentures to the distressed securities arms of major investment banks, and other "vulture" investors.[141] Quite understandably, these secondary purchasers pay much less than par for the debentures.

When the issuing firm enters Chapter 11, it will have a class of bondholders that is actually comprised of two types of holders, each with quite divergent interests. On the one hand, the holders that bought the debentures at face value will view anything less than payment of the full face amount of the debentures as a loss. The secondary purchasers, however, will view any recovery that is greater than their purchase price, even if less than par, as a gain.

If the secondary investors purchased the debentures for ten cents on the dollar, a plan that offers a forty percent recovery represents a tremendous gain to the secondary purchasers, and a sixty percent loss to the holders who bought in at face value. Thus, the assumption in many academic articles that creditors of equal priority stand united against the debtor, and creditors of other priorities, quickly falls apart under a more realistic conception of financial distress. This calls into question the likelihood of quick coordination on an optimal disposition of the debtor. Once intraclass conflict is recognized, the proposition that strict enforcement of the absolute priority rule will dissipate potential creditor conflicts, as argued by Professor Schwartz and others, also becomes suspect.

4. *The Ambiguous Nature of Ex Post Adaptability*—While it would be easy to assume that efforts to enhance adaptability in corporate reorganization invariably increase overall costs–and most existing critiques of Chapter 11 rest upon just such an assumption–the true impact these changes is unclear. For example, lenders value statutory and contractual provisions that allow for a regularized and comprehensive restructuring process. When the possibility of default is deemed remote, the lender may feel that

141. Many such institutional holders–such as insurance companies and trust departments–may face statutory or institutional bars on holding distressed securities.

only an exceptional event would lead to a default. Under these circumstances, the potential need to give an otherwise laudable borrower a "second chance" may warrant *ex post* flexibility.

The common assumption that Chapter 11 enhances the overall costs of borrowing may only hold for less creditworthy borrowers. Flexibility presents a significant moral hazard problem with respect to these borrowers. On the other hand, when a loan is made with an understanding that the chances of default are quite high, the parties may anticipate the need for restructuring and thus value flexibility in these instances as well. Consequently, even in the case of high-risk borrowers, the effect of flexibility on the overall cost of borrowing is unclear, and the costs and benefits of various rules may tend to operate in contrary directions. Absent empirical data, it simply cannot be assumed that provisions that enhance the debtor's ability to reorganize will invariable lead to any specific overall result.

IV. Conclusion

In 1916, the poet Siegfried Sassoon—then an experienced infantry officer serving at the western front—was sent to an officers training school for a "refresher course." After the war, Sassoon recalled that

> Although I was closely acquainted with the mine-craters in the Fricourt section, I would have welcomed a few practical hints on how to patrol those God-forsaken cavities. But the Army School instructors were all in favor of Open Warfare, which was sure to come soon, they said. They had learnt all about it in peace time; it was essential that we should be taught to "think in terms of mobility."[142]

The obvious point being that the gulf between theory and practice is hardly new and not confined to law. But if Chapter 11 theory is going to be something more than wishful thinking—Open Warfare lessons for soldiers in trenches—it must have some rooting in the existing reality of corporate reorganization.

As the prior sections have illustrated, existing Chapter 11 theory has developed to serve a type of firm, and a type of proceeding, that exists only in academia. Existing models are not simplified versions of the reality of corporate reorganization, but

142. SIEGFRIED SASSOON, *Memoirs of an Infantry Officer*, *in* THE MEMOIRS OF GEORGE SHERSTON 11 (Literary Guild Edition 1937).

instead models of a highly stylized process. This is the ultimate failing of existing Chapter 11 theory.

My point is not to argue that theory should never begin with simplified models. Clearly, some degree of abstraction is needed in any theory, and key insights are often gained from examining certain elements of a theory in the isolation provided by a simplified model. The difficulty arises when the simplified model can not be translated in a way that connects the model to a more complex reality.

Any proposed change to a complex system must come from an understanding of how that system works. At present, Chapter 11 theory instead comes from an unstated belief that a new reality can be imposed from above, without regard for the preexisting reality. In this light, it is hardly surprising that Chapter 11 theory has failed.

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