

# WHEN BANKRUPTCY MEETS ANTITRUST: THE CASE FOR NON-CASH AUCTIONS IN CONCENTRATED BANKING MARKETS

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## INTRODUCTION

Just about three years ago, in light of the financial collapse of Enron, Douglas Baird and Robert Rasmussen dramatically announced that the U.S. privately negotiated reorganization regime, known worldwide simply as Chapter 11,<sup>1</sup> is effectively dead.<sup>2</sup> Two of the most notable bankruptcy law scholars of the last two decades, Baird and Rasmussen have continuously criticized the fundamental principles of Chapter 11 and have been calling for its replacement by market-based bankruptcy regimes.<sup>3</sup> In *The End of Bankruptcy* they argued that the actual practice proves that most Chapter 11 cases are streamlined towards a public sale of the corporate debtor, either as a sale of its assets or as a sale of the equity interests therein. Thus, in their eyes, the contours of Chapter 11, envisioning an internally negotiated reorganization plan between the debtor and its creditors, no longer rule and rightfully so.<sup>4</sup> Others disagree with the generalization reflected in Baird and Rasmussen's contention. For example, Lynn LoPucki has countered by contesting Baird and Rasmussen's argument in light of a systematic compilation of corporate bankruptcy data that he has accumulated over the years.<sup>5</sup> The broad strokes with which Baird and Rasmussen chose to depict contemporary U.S. bankruptcy law notwithstanding, the practice appears to indeed mitigate the theoretical dichotomy between a prototypical private-bargaining bankruptcy regime and a market-based

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<sup>1</sup> Chapter 11 of the Bankruptcy Code is codified at 11 U.S.C. §§ 1101- 1174.

<sup>2</sup> Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751 (2002).

<sup>3</sup> See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 Va. L. Rev. 921 (2001); Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. Ill. L. Rev. 1; Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51 (1992); D.G. Baird, *A World Without Bankruptcy*, 50 L. & Contemp. Problems 173 (1987); Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. Legal Studies 127 (1986) (hereinafter: Baird, *Uneasy Case*).

<sup>4</sup> Baird & Rasmussen, *supra* n2.

<sup>5</sup> Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 Stan. L. Rev. 645 (2003).

bankruptcy regime. Yet, the strong academic debate concerning the superiority of any of these prototypes seems to live on.<sup>6</sup>

The academic debate surrounding the normative bankruptcy law seems at times to touch the most sensitive nerves of political and social science, confronting orthodox libertarians and modern liberals and socialists.<sup>7</sup> Close examiners of the themes underlying the grand academic debate over bankruptcy law will quickly identify the specific flavor of *U.S.* bankruptcy law. The debate has always been all about Chapter 11. Either a scholar liked it or opposed it all together. In recent years, Chapter 11 has become a measuring stick against which various Western World countries examine their own bankruptcy laws. Many countries have considered enacting a corporate reorganization regime which would follow, at least partially, the model of Chapter 11. Accordingly, the grand academic debate has been exported to other continents as well. With respect to this fascinating and heated academic debate, this article follows the realistic acknowledgement of prominent scholars such as Mark Roe and Oliver Hart, who understand that innovative theoretical models for bankruptcy reform, which have been proposed over the years, may be inapplicable for certain countries because they are either politically unacceptable<sup>8</sup> or incompatible with those countries' economic structures.<sup>9</sup> Thus, once one overcomes the urge to single-handedly save the world by introducing an ultimately triumphant bankruptcy model, the debate merits concretization and focus on actual countries or economic environments.

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<sup>6</sup> With respect to U.S. law specifically, however, Omer Tene contends that the "grand" academic debate concerning the desirability of Chapter 11 altogether and whether its existence is at all justifiable has given way to a more "moderate" debate, which takes the existence of Chapter 11 as a given and thus addresses internal Chapter 11 issues in an attempt to improve its overall functioning. Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 Bank. Dev. J. 287 (2003).

<sup>7</sup> See S. Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 Ill. L. Rev. 503, 510-518 (describing the "great divide" in bankruptcy theory).

<sup>8</sup> See Mark J. Roe, *Backlash*, 98 Colum. L. Rev. 217, 236 (1998).

<sup>9</sup> See Oliver Hart, *Different Approaches to Bankruptcy*, NBER Working Paper 7921, (2000) available at <http://www.nber.org/papers/w7921.pdf> ("It is unlikely that 'one size fits all' ... Which procedure a country chooses or should choose may ... depend on other factors, *e.g.*, the country's institutional structure and legal tradition ... It is important to recognize that bankruptcy reform should not be seen in isolation: it may be necessary to combine it with legal and other reforms, *e.g.*, the training of judges, improvements in corporate governance and the strengthening of investor rights, and possibly even changes in the international financial system."). Indeed, the very diversity of existing corporate and bankruptcy laws around the world may be explained as an evolutionary result of different preexisting legal, economic and political conditions. See Mark J. Roe, *STRONG MANAGERS – WEAK OWNERS* (1994) (developing the path dependency narrative of the evolution of contemporary corporate governance of publicly traded U.S. corporations); David A. Skeel, Jr., *DEBT'S DOMINION – A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2001) (analyzing the gradual development of U.S. bankruptcy law based on the driving forces in the American economy and politics at the time); Bruce H. Mann, *REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE* (2002).

This article focuses on a wide spectrum of countries, the common denominator of which is that their economy is considerably characterized by the dominant role the local banks play in financing most of the corporate activity. The article will demonstrate the realistic relationship between banking dominance and the functioning of various bankruptcy law models. In concentrated banking economies, banks are strongly involved in two phases of a typical corporate bankruptcy case. First, they stand to collect from the firm as the senior secured creditors of the corporate debtor. Secondly, often those banks are the financing sources for the operation of the distressed firm while it undergoes bankruptcy and for the emergence of that firm out of bankruptcy. In concentrated banking, the number of banks available for corporate financing is rather limited. This makes the bank's position in bankruptcy crucial for the entire outcome of the case. Unfortunately, the oligopolistic structure of the banking industry in such economies exposes the corporate debtors and their non-bank creditors to extensive risks. As shall be elaborated later,<sup>10</sup> the banks might use their stronghold over the corporate fate to extract excessive interest rates and limit their bankruptcy-ending financing in a conservative manner. In addition, during negotiations over financing the exit from bankruptcy an *ad hoc* debtor-bank or acquirer-bank coalition might be formed which would result in the squeezing out of the junior creditors. Thus, corporate bankruptcy regimes which are effectively bank dependent might fail to fulfill satisfactorily bankruptcy law policy. That is, under such regimes it is doubtful whether the firm's resources would be allocated to their highest-valuing user and whether bankruptcy would maximize the return to the corporate creditors as a whole.<sup>11</sup>

To fully appreciate the close interaction between corporate bankruptcy and the structure of a country's banking industry one must first clearly categorize the various bankruptcy law models often compared in the academic literature. There exist various bankruptcy laws around the world which include a chapter on corporate reorganization or rescue. The first step often taken in pursuit of this goal is a statutory or judicially imposed moratorium, temporarily staying all collection actions against

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<sup>10</sup> See Part III *infra*.

<sup>11</sup> On the goals of bankruptcy law compare Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336 (1993) (emphasizing both allocative efficiency and distributive goals); with Barry Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. Rev. 343 (1997); Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 Yale L.J. 573 (1998); Hart, *supra* note 9 (all emphasizing efficiency as the compass for normative bankruptcy law).

the corporate debtor.<sup>12</sup> But beyond this immediate relief, the ultimate goal of the case is to effectuate a reorganization plan that would assist the firm to exit bankruptcy while maintaining its core business.<sup>13</sup> This plan can be designed and constructed in a variety of ways. Two basic prototypes stand out in the literature on corporate reorganization. The first is a reorganization plan which is negotiated privately by the person in control of the reorganizing firm and its creditors. This prototype thus entails an endogenous reorganization, in that it involves only the debtor's prebankruptcy actors: managers, creditors and the old equityholders. The second reorganization prototype turns exogenously to the forces of the market. Under this prototype, bankruptcy either utilizes a public auction of the debtor firm and awards the control thereof to the highest bidder<sup>14</sup> or applies one of a variety of similar sophisticated mechanisms which would determine in an economic fashion the residual economic stakeholder in the firm.<sup>15</sup> This prototype opens the bankruptcy case to new actors and allows *any* person, whether previously related to the debtor (holding claims against it or equity interests therein) or not, to participate in the crafting of a financial solution for the ailing debtor by bidding for its future control and operation.<sup>16</sup>

Chapter 11 has been under academic fire, especially from the law and economics wing, primarily because of two reasons. First, because it leaves management with a superior bargaining position vis-a-vis the corporate creditors.<sup>17</sup> Secondly, in its early days, Chapter 11 channeled the resolution of the corporate distress to exclusive bargaining between the prebankruptcy parties, rather than opening the corporate gates for a market evaluation of the firm.<sup>18</sup> As noted above, the academic critics of

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<sup>12</sup> For a statutory imposed automatic stay *see* the U.S. Bankruptcy Code § 362(a). For a judicially imposed moratorium *see, e.g.*, The Insolvency Act, 1986 § 11(3) (U.K.); Bankruptcy and Insolvency Act s. 69 (Canada); The Faillissementswet § 213 (The Netherlands).

<sup>13</sup> Unless it is concluded that the corporation has no viable business worth rescuing, in which case the trustee will move for converting the case to liquidation.

<sup>14</sup> *See* Part I.B.1 *infra*.

<sup>15</sup> *See* Part I.B.2 *infra*.

<sup>16</sup> Barry Adler lists two prototypes of bankruptcy law somewhat differently. The first, an *ex post* approach to corporate insolvency, empowers a court to supervise the insolvent firm and determine its subsequent fate, whether it be reorganized or liquidated. The alternative prototype is an *ex ante* approach to corporate insolvency, under which upon the financial state of insolvency a firm strictly adheres to its investors' predetermined contractual undertaking as of the time of investment. Adler, *supra* n.11.

<sup>17</sup> Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 Yale L.J. 1043 (1992).

<sup>18</sup> This interpretation of Chapter 11 has been modified by the Supreme Court in 1999. The Court held that whenever a reorganization plan is proposed by the debtor and purports to leave value to the equityholders while certain creditors shall not get paid in full, the field automatically opens for the

Chapter 11 have been calling for its substitution by market-based mechanisms. Yet the market-based models developed in the literature share a basic characteristic: they all entail the use of cash at the exit point upon which the firm is to emerge from bankruptcy. The underlying assumption of these models was that raising the requisite cash is not a problematic issue. However, subsequent papers started to question this simplistic assumption and raised the concern whether these models could work when cash is not readily available as presumed. This paper joins those who are concerned that cash constraints may prove certain models inadequate. In particular, it adds to this skepticism the dimension of concentrated banking. This paper will illuminate how the banking oligopoly may distort the efficient functioning of cash-driven models of corporate bankruptcy. It will show that such regimes would simply not work in concentrated banking economies.

In light of the shortcomings of the cash-driven models of bankruptcy, the approach I suggest herein is to adopt *non-cash* bankruptcy auctions as the model for concentrated banking economies. Non-cash auctions enjoy the benefit of relying on market-based valuations of the firm. Yet, in departing from cash payments, this proposed bankruptcy model may reduce the dependency of the various actors, most notably potential bidders, on the dominating banks' financing. This in turn would level the ground for the auction by allowing bidders to value the debtor firm based on their own valuations rather than on the banks'. Encouraging *independent* valuations in such a fashion would, in my eyes, facilitate meeting the goal of handing the firm to its highest-valuing user. It would also maximize the overall return to the prebankruptcy creditors as a whole.

This paper is developed as follows: Part I outlines the principal contours of the two prototypical corporate bankruptcies. First, it describes the workings of privately-negotiated bankruptcies, such as Chapter 11. The analysis will emphasize the main flaw which the literature has found in this prototype, namely that it is an invitation to distort the valuation of the firm due to inequality of bargaining positions inside the bankruptcy arena. Subsequently, the market-based models of bankruptcy are analyzed. This analysis will distinguish more particularly between proposals calling for the outright auction of the distressed firm<sup>19</sup> and models which have called for the

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presentation of competing proposals before confirmation of the plan. *Bank of America National Trust and Savings Assoc. v. 203 North La Salle St. Partnership*, 526 U.S. 434 (1999).

<sup>19</sup> See the Baird Proposal in Part I.B.1 *infra*.

conversion of the prebankruptcy claims into new reorganization rights prior to making the final resolution on the firm's fate.<sup>20</sup>

Part II will temporarily abandon the bankruptcy discourse in order to set the stage and introduce the specific nature of concentrated banking economies. The phenomenon of concentrated banking has been the subject of various economic studies in recent years. A main theme in this research is trying to address the question whether such a structure of a country's financial market is overall good or bad. Not surprisingly, the opinions have been split over this matter. But what the literature can tell us is, that even assuming that the overall effect of concentrated banking is constructive, it bears nonetheless potential risks for borrowing firms. The most apparent risk is the limited supply of financing sources and difficulties it creates for developing businesses by entrepreneurs.

This paper will avoid taking sides in the concentrated banking debate. Rather, it wishes to relate the risks associated with concentrated banking to the functioning of various bankruptcy models. This task is undertaken in Part III of the paper. This part integrates the various models of bankruptcy discussed previously into the melting pot of a concentrated banking economy and tests the outcome. It shows that cash-driven models of bankruptcy are likely to fail as the bank's position as the ultimate and sole suppliers of financing for the bankruptcy resolution would adversely affect this resolution. The banks enjoy a close-knitted oligopoly in which the financing terms of one are easily revealed by the others. The paper will show that the joint interest of the banks is to reduce the financing for acquiring control of a distressed firm and to set that financing at a level which is a function of the senior lender's prebankruptcy claim. This limitation will at times deny identifying the highest valuing-user. Thus, cash-driven bankruptcy models are simply tailored for economies in which actors in the market enjoy a diversity of financing sources, but are incompatible with the conditions of concentrated banking.

As a result of the failure of cash-driven bankruptcy models, Part IV proposes to adopt a soft version of exogenous bankruptcy. That is, the proposal endorses the concept of subjecting the elusive value of the distressed firm to market forces. Thus, an open and unlimited auction for the control of the firm should take place. However, given the severe financing obstacle bidders face in concentrated banking economies,

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<sup>20</sup> See the Bebchuk Proposal and the AHM Proposal in Part I.B.2 *infra*

this paper calls for allowing *non-cash* auctions to take place. In such auctions, bidders would value the firm without necessarily having to raise cash upfront. The winning bidder would pay off the firm's debts to its creditors through installment payments or through the conversion of part of those claims into equity rights in the firm. Such a system would encourage bidding for the control of the firm. The enhanced competition is likely to generate more reliable valuations of the firm. Nonetheless, the proposal also clarifies that because this system does not employ actual realization of the firm's assets, the bids and the valuations reflected therein must be forwarded to the approving vote of the firm's creditors.

## **I. Corporate Reorganizations: A Tale of Two Prototypes**

Bankruptcy practice exhibits two distinct types of corporate resurrection. One employs endogenous efforts of the debtor and its creditors to overcome the existing financial crisis by rearranging the creditors' prebankruptcy claims and converting parts thereof into newly issued debt or equity instruments. This type shall be referred to as private bargaining reorganization. The other relies on exogenous forces to step in and acquire the control of the corporate enterprise while paying off the prebankruptcy claims. This type shall be referred to as market based corporate reorganization. This part examines the contours of each of these reorganization schemes and outlines their distinctive characteristics. In order to emphasize the fundamentals of each reorganization prototype and its relative strengths or weaknesses the analysis will assume, at this point, that all markets are alike and disregard the specific characteristics of different types of economies around the world. Thus, any country is assumed to be ripe for adopting either the endogenous or the exogenous reorganization regime. Later, in Parts III and IV of this paper, the assumption of homogeneity of countries shall be relaxed in favor of the real world's diversity of economic systems. The compatibility of each of the two prototypes to certain types of economies shall then be examined more specifically.

### **A. Private Bargaining**

#### *1. Crafting a Reorganization Plan*

In a private bargaining reorganization, the debtor and its creditors engage in extensive negotiations towards the development of a comprehensive reorganization plan. Reorganization plans contain two major parts. The first is a business plan for



the future operation of the reorganized firm. The second part deals with the retirement of the corporate outstanding debt. The plan must specify the method of payment, whether by means of a cash payment, installment payments, or conversion of debt to equity interests, including all modifications to the original rights of the creditors (*i.e.* the prepetition claims) as a result of the payment means utilized thereunder. The trademark of a private bargaining reorganization is that, unlike in a liquidation case, there is no actual sale of the corporate assets (whether as a whole or piecemeal).<sup>21</sup> The corpus of the corporate business remains intact. While the capital structure of the company is restructured, no realization of the assets ever takes place.<sup>22</sup> The restructuring of the corporate capital necessitates a valuation of the corporation. The valuation is imperative in connection with the second element of a reorganization plan. That is, a valuation of the corporation is required for determining the payoffs of the prebankruptcy claims. In bankruptcy, the satisfaction of the creditors' approved claims is based on the absolute priority rule.<sup>23</sup> Under this rule, any distribution of value to a group of creditors may be done only if there is enough value remaining in the corporate assets after full satisfaction of the senior ranking claims.<sup>24</sup> The greater the value assigned to the corporation, the farther the distribution to creditors goes.

## 2. *The Valuation Distortion*

Absent actual realization of the corporate assets through a liquidation sale, the valuation of the debtor corporation remains an inexact science at best. There are no verifiable monetary figures extracted from an actual sale of the assets.<sup>25</sup> Rather, valuation is a matter of intelligent probabilistic estimation of the debtor's future performance.<sup>26</sup> It is based on the analysis of economic experts. Such analyses are

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<sup>21</sup> See Thomas H. Jackson, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 201-212 (1986); Douglas G. Baird, *ELEMENTS OF BANKRUPTCY* 198-206 (3<sup>rd</sup> ed. 2001).

<sup>22</sup> Lucian Arye Bebchuk, *A New Approach to Corporate Reorganization*, 101 *Harv. L. Rev.* 775, 778 (1988) (hereinafter: Bebchuk, *New Approach*); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 *Stan. L. Rev.* 311, 314 (1993); Baird, *Uneasy Case*, *supra* n.3, at 127-128.

<sup>23</sup> The phrase "absolute priority rule" was first coined in James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 *Colum. L. Rev.* 127 (1928).

<sup>24</sup> For a statutory expression of the absolute priority rule, see Bankruptcy Code § 1129(b).

<sup>25</sup> David G. Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 *Am. U.L. Rev.* 63, 70-74 (1991).

<sup>26</sup> *Cf.* Commissioner of Internal Revenue v. Marshall, 125 F.2d 943, 946 (2<sup>nd</sup> Cir. 1942) ("The fallacy in that argument stems largely from lack of recognition of the eely character of the word 'value'. It is a bewitching word which, for years, has disturbed mental peace and caused numerous useless debates. Perhaps it would be better for the peace of men's minds if the word were abolished. Reams of

ordered by interested parties. Unfortunately, the experience of recent years proves more than ever before that the use of experts' analyses to substantiate a valuation of a corporation is an invitation to introduce self-interested valuations that serve the strategic cause of the party ordering the valuation.<sup>27</sup> Indeed, to the extent the valuing person lacks complete independence in its valuation of the corporation, its economic ties with the ordering party, its compensation for the valuation, or its own stake in the entity being valued, is liable to compromise its valuation.<sup>28</sup> In the context of valuation for the purpose of reorganization, the various creditors and the equityholders face conflicting interests in this respect, and thus invite subjective, self-serving, strategic valuations of the debtor.<sup>29</sup> The senior creditors seek a conservatively low valuation of the debtor corporation, because this would make them the exclusive economic owners of the reorganized corporation.<sup>30</sup> On the other hand,

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good paper and gallons of good ink have been wasted by those who have tried to give it a constant and precise meaning... And there, as almost always, 'value' involves a conjecture, a guess, a prediction, a prophecy... 'Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future; and the value is no less real ... if later the prophecy turns out false than when it comes out true.' *Ithaca Trust Co. v. United States*, 279 U.S. 151, 155, 49 S.Ct. 291, 292, 73 L.Ed. 647.")

<sup>27</sup> Stephen J. Leacock, *The Anatomy of Valuing Stock in Closely Held Corporations: Pursuing the Phantom of Objectivity in the New Millennium*, 2001 Colum. Bus. L. Rev. 161, 165 (2001); Park McGinty, *The Twilight of Fiduciary Duties: On the Need to Shareholder Self Help in an Age of Formalistic Proceduralism*, 46 Emory L.J. 163, 205-212 (1997); David G. Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 Am. U.L. Rev. 63, 70-74 (1991); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69, 120 (1991).

<sup>28</sup> This is perhaps the greatest lesson the entire accounting practice has learned first-hand from the Enron debacle. See *"Who Fiddled What? 'Errors of Judgment' are Piling Up at Andersen"*, *The Economist*, Dec. 22, 2001; David Barboza, *Enron Inquiry Now Focusing on Valuations*, *The New York Times*, May 13, 2002; Joseph Fuller and Michael Jensen, *End the Myth-Making and Return to True Analysis: Viewpoint Joseph Fuller and Michael Jensen: Analysts' Forecasts Have Become Too Powerful and it is Time for Companies to Stop Colluding with their Inflated Expectations*, *Financial Times* (London, England), Jan. 22, 2002; Harvey Rice, *The Fall of Enron; Sources Say Assets of Driller Inflated*, *The Houston Chronicle*, Sept. 22, 2002; Connor Dignam, *Choosing the Winners in the Brand Value Game: Cash Valuations Alone do not Fully Reflect the Strengths and Weaknesses of the World's Top Brands*, *Financial Times*, Aug. 6, 2002; Andrew Hill and Sheila McNulty, *Energy Groups under Renewed Pressure Mark-To-Market Accounting*, *Financial Times*, Jan. 31, 2002; Peter Martin, *Always Expect the Unexpected: Enron's Collapse Should Remind Us that No Accounting or Valuation Technique Can Disguise the Inherent Riskiness of Business*, *Financial Times*, Jan. 29, 2002.

<sup>29</sup> On the creditors' subjective valuation see John M. Czarnetzky, *Time, Uncertainty and the Law of Corporate Reorganizations*, 67 *Fordham L. Rev.* 2939, 2985 (1999).

<sup>30</sup> This strategic calculation by a senior creditor is applicable when the creditor assumes that its claim might be valued lower than the firm's aggregate value and that the plan allocates equity interests in exchange for the prebankruptcy claims. See Adler, *supra* n.22, at 318. In the case of a secured creditor who is concerned that its collateral is likely to be valued lower than its claim (that is, an undersecured claim) and that the payoff will be in debt instruments, the creditor's interest is to attempt inflating the value of the collateral, in order to increase its secured claim and decrease its unsecured deficiency claim. See Lucian Arye Bebchuk & Jesse M. Fried, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 *Harv. L. Rev.* 2386, 2398-2401 (2001).

junior claimants and even more so the old equityholders are in search of a high valuation of the corporation, in hope of retaining a stake in the reorganized corporate capital.<sup>31</sup> Thus, privately negotiated reorganization plans entail the risks of over- or undervaluation, depending on the particular valuation introduced.<sup>32</sup> Either way, the distribution of value amongst the various classes of claims is liable to be distorted and fail to reflect the true economic stakes in the corporation. Privately negotiated reorganization plans increase the probability of transfer of value from one class to another based on the relative bargaining leverage each negotiating party holds. In addition, self-interested valuations violate the economic goal of placing the corporate assets in the hands of their most efficient user.<sup>33</sup> In short, the valuation distortion undermines the reliability, the efficiency and the fairness of the privately negotiated reorganization scheme as a means for resolving the financial crisis of a corporation. Nonetheless, the valuation distortion in private bargaining reorganizations may be ameliorated by entrusting the entire valuation process in the exclusive hands of an independent person, free from any biases of the old management, shareholders or classes of creditors. Indeed, in various insolvency regimes around the world an appointed trustee is the person that is required to evaluate the corporation and propose a payment plan based on the corporation's assigned value.<sup>34</sup> The trustee is considered an objective party as it is free of preexisting economic stakes in the corporation.<sup>35</sup>

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<sup>31</sup> Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. Applied Corp. Fin. 13, 31 (1991); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 Colum. L. Rev. 527, 547-548 (1983); Bebchuk, *New Approach*, supra note 22, at 779; Robert F. Reilly, *Valuation - Big Businesses vs. Small*, 1995 ABI JNL Lexis 126 (1995); Chaim J. Fortgang & Thomas M. Mayer, *Valuation in Bankruptcy*, 32 UCLA L. Rev. 1061, 1063-1066 (1985); J. Bradley Johnston, *The Bankruptcy Bargain*, 65 Am. Bankr. L.J. 213, 264-265 (1991).

<sup>32</sup> Fortgang & Mayer, supra note 31, at 1105-1107; Bebchuk, *New Approach*, supra note 22, at 780; Bradley, *The Bankruptcy Bargain*, supra note 31, at 241.

<sup>33</sup> Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & Econ. 633, 634 (1993) (hereinafter: Baird, *Auctions Revised*); Baird, *Uneasy Case*, supra n.3, at 133.

<sup>34</sup> See, e.g., in the U.K., G. Lightman & G. Moss, *THE LAW OF RECEIVERS AND ADMINISTRATORS OF COMPANIES*, 457-459 (2000); 2-21 COLLIER INTERNATIONAL BUSINESS INSOLVENCY GUIDE 21.05 [d][i][vi] (Richard F. Broude ed., 1999); Robert R. Pennington, *PENNINGTON'S CORPORATE INSOLVENCY LAW*, 327 (1991); M. Phillips & J. Goldring, *Rescue and Reconstruction*, 15 *Insolv. Int.* 75, 75-78 (2002). Cf. F. Tolmie, *INTRODUCTION TO CORPORATE AND PERSONAL INSOLVENCY LAW*, 107-112 (1998).

<sup>35</sup> The identity of the person or group controlling the corporation while its undergoing reorganization has been recently acknowledged as a central issue in analyzing the efficacy of any particular reorganization regime. See Baird & Rasmussen, supra note 3. See also John Armour, Brian R. Cheffins & David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 *Vand. L. Rev.* 1699 (2002); David A. Skeel, *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 *U. Pa. L. Rev.* 917 (2003); D. Hahn, *Concentrated Ownership and Control of Corporate Reorganizations*, 4 *J. Corp. L. Stud.* 117 (2004).

This position a trustee enjoys ostensibly portrays a valuation it ordered as a bias-free valuation of the financially distressed corporation.<sup>36</sup>

## B. Market Based Bankruptcies

### 1. Public Auctions

#### *a. Auctions of Distressed Firms in Practice*

The alternative reorganization prototype is one that in lieu of privately bargaining a plan between the preexisting management, equityholders and creditors, puts the firm up for sale on the market and seeks the highest bid thereon. The proceeds of the sale paid by the winning bidder are used to pay off the prebankruptcy claims based on the absolute priority rule. Indeed, such an approach to corporate bankruptcy can be found in practice in Sweden.<sup>37</sup> A Swedish insolvent firm may propose a compromise plan, but only with its *unsecured* creditors. Because this scheme is partial in its nature and excludes the treatment of secured creditors and priority claims, these creditors can refuse full payment to the unsecured creditors and thus frustrate the effectuating of a workable plan. Thus, it is seldom used.<sup>38</sup> Rather, the common alternatives available for insolvent firms are to arrange a sale of the firm's assets and repay the creditors out of the proceeds received therefrom. Two paths of sales are available. The first path is a "pre-pack sale", which is arranged out-of-court by the management and approved by the secured creditors. Upon the execution of the sale, the firm files for bankruptcy primarily to allow junior creditors to oppose the sale in court, overturn it and effectuate an auction in lieu.<sup>39</sup> The second path of sale takes place through a court-controlled bankruptcy case. Upon the filing for bankruptcy, an automatic stay is imposed against all debt collection, including the foreclosure on collateral. In addition, fresh financing and trade credit are accorded super-priority status.<sup>40</sup> A court-appointed trustee takes control of the firm in order to auction its assets. The

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<sup>36</sup> Oliver Hart, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* 174-8 (1995).

<sup>37</sup> Due to my nonexistent skills in deciphering any Swedish text, the description of the Swedish model that unfolds herein is based on its description in English in B. Espen-Eckbo & Karin S. Thorburn, *Overbidding vs. Fire-Sales in Bankruptcy Auctions*, ¶ 3.1 (hereinafter: Espen-Eckbo & Thorburn, *Fire-Sales*), <http://ssrn.com/abstract=299384> (2002).

<sup>38</sup> Espen-Eckbo & Thorburn note that only 4 cases of successful compositions were reported in comparison to 300 bankruptcy filings for 1,650 financially distressed firms. See Karin S. Thorburn, *Bankruptcy Auctions: Costs, Debt Recovery, and Firm Survival*, 58 J. Fin. Econ. 337, 342 (referring to B. Espen-Eckbo & Karin S. Thorburn, *unpublished manuscript* (2000).)

<sup>39</sup> Empirically, pre-pack sales are hardly ever overturned. Espen-Eckbo & Thorburn, *Fire-Sales*, supra n.37.

<sup>40</sup> In practice, firms generate most of their bankruptcy financing through trade credit rather than through financial credit. Id.

auction normally takes place within several weeks of the bankruptcy filing. The firm's assets are auctioned by the trustee either as a going-concern, usually in the form of a merger into a surviving corporation, or piecemeal. The consideration offered in the auction must be in cash. The creditors are paid out of the auction's proceeds in strict adherence to the absolute priority rule.

b. *The Virtues of Bankruptcy Auctions*

i. Obtaining the True Value of the Firm

An auction approach to the solution of corporate distress is predicated on pure economic theory. Classic auction theory, developed by Vickrey and later Weber and Milgrom, holds that auctions, whether conducted as open English auctions, Dutch auctions, or sealed bids auctions,<sup>41</sup> generate the true value of the good being auctioned.<sup>42</sup> Bulow and Klemperer showed that the competition existent in an auction makes this procedure preferable to a privately negotiated sale, notwithstanding the bargaining skills and control of the seller.<sup>43</sup> Under auction theory, an auction-based bankruptcy system substitutes a market valuation of a debtor corporation for a mechanism of private bargaining over the value between the existing groups of investors alone.<sup>44</sup>

During the late 1980s and early 1990s, prominent law and economics scholars, the most vocal of whom has been Douglas Baird, advocated consistently for the repeal of the U.S. Chapter 11's private bargaining approach to reorganization in favor of an auction regime.<sup>45</sup> Indeed, valuing the future performance of a corporation is complex.

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<sup>41</sup> An English auction is an open, ascending auction, where the price is successively raised until eventually a bidder wins as the highest bidder. A Dutch auction is the reverse: an open, descending auction, where the price is successively reduced by the auctioneer until the first bidder calls out that she is willing to meet that price. A sealed-bid auction is one where each bidder places her bid without knowledge of the others' bids, and the highest bidder wins the auction. That winner will pay its original highest bid (under the first-price sealed-bid model) or the second highest bidder's bid (under the second-price sealed-bid model). See Paul Klemperer, *Auction Theory: A Guide to the Literature*, 13 J. Econ. Surveys 227 (1999).

<sup>42</sup> See William Vickrey, *Counterspeculation, Auctions and Competitive Sealed Tenders*, 16 J. Fin. 8 (1961); Robert J. Weber & Paul R. Milgrom, *A Theory of Auction and Competitive Bidding*, 50 *Econometrica* 1089 (1982); Paul Milgrom, *Auction and Bidding: A Primer*, 3 J. of Econ. Persp. 3 (1989). See also Robert Wilson, *A Bidding Model of Perfect Competition*, 44 *Rev. of Econ. Stud.* 511 (1977) (claiming that in sealed bids, assuming true competition, the seller will receive the true value even if that value is not known prior to the bidding).

<sup>43</sup> Jeremy Bulow & Paul Klemperer, *Auction Versus Negotiation*, 86 *Am. Econ. Rev.* 180 (1996).

<sup>44</sup> Jackson, *supra* note 21, 221-24; Adler, *supra* note 11, at 347; Roe, *supra* note 31 at 559.

<sup>45</sup> The classic papers developing an auction approach to corporate bankruptcy are Baird, *Uneasy Case*, *supra* n.3; Jensen, *supra* n. 31, at 29-32. Baird's auction approach for bankruptcy received later

It involves the making of assumptions, projecting the income stream based on those assumptions, and then multiplying the projected income by the probabilities of meeting the projections. Under auction theory, the optimal valuation of the firm would be obtained by leaving the valuation task to the forces of the market. Put simply, the auction-based bankruptcy proponents call for placing the firm in the hands of the user that assigns the highest value thereto. That user may be one or more of the groups of creditors of the corporation, the old equityholders, *or a third-party*. A privately-bargained plan allocates the corporate assets solely to the persons with whom the proponent negotiated and struck a deal. Usually, those persons will be preexisting creditors or equityholders. But such persons may not be the best users of the corporate assets. Obtaining the efficient allocation of resources in the context of corporate reorganization requires a process in which *any* prospective user of the corporate resources may bid and propose to take control of the corporation. A general invitation to bid on the corporate assets and their future use is embodied in the process of an auction.<sup>46</sup>

ii. Avoiding a Judicial Valuation of the Firm

The proponents of the auction model of corporate reorganization highlight a crucial institutional shortcoming of the privately-bargained reorganization prototype. In a private-bargaining reorganization, after the proponent of the plan presented the underlying valuation on which the plan is based and although the creditors vote on the proposed plan, the ultimate decision on the acceptance of the plan with its underlying valuation is to be made by a bankruptcy judge upon confirmation of the plan.<sup>47</sup> In contrast, in an auction-based regime, no institution is called upon to value the

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support from Robert G. Hansen & Randall S. Thomas, *Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance*, 18 Int'l Rev. L. & Econ. 159 (1998). Cf. William H. Meckling, *Financial Markets, Default and Bankruptcy: The Role of the State*, 41 L. & Contemp. Prob. 13, 37-38 (1977).

<sup>46</sup> Frank Easterbrook casts some serious doubts concerning the theory that auctions are supreme to reorganization under chapter 11 in reducing social costs. Easterbrook points to the lack of resort to (prebankruptcy) auctions by creditors and the complete disregard of the auction alternative during the extensive and elaborate legislation process of the Bankruptcy Reform Act of 1978, including by representatives lending institutions as indicators that despite the academic call for auctioning insolvent firms, the legal chapter 11 course might be economically preferable. See Frank H. Easterbrook, *Is Chapter 11 Efficient*, 27 J. Fin. Econ. 411 (1990). Cf. Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 Stan. L. Rev. 1 (1982) (arguing that given the sunk costs of an initial bidder for the control of a firm in a tender offer, imposing on management an affirmative duty to auction the firm following this initial bid adversely affects *ex ante* the incentives of any prospective (initial) bidder to invest in information for acquisition of the firm and thus reduces efficient monitoring of the firm's agents, to the detriment of investors).

<sup>47</sup> See, e.g., Bankruptcy Code § 1129(a) (U.S.); Insolvency Act, 1986 § 4A(6) (U.K.).

corporate debtor. That mission is left exclusively to the free forces of the market. Many have questioned the competence of judges to make such complex valuation judgments and accordingly support a market-based bankruptcy prototype.<sup>48</sup> Nonetheless, certain recent articles counter this argument by contending that holding market-based sales in bankruptcy entail expensive and lengthy procedures comparable to the average cost and time a typical Chapter 11 bargaining takes<sup>49</sup> and that such sales are conducted as fire-sales generating prohibitively low returns for the creditors.<sup>50</sup>

### iii. Countering Management's Control Leverage

By placing the firm for sale on the open market an auction-based bankruptcy regime achieves another, albeit related, constructive goal. It removes much of the distorted leverage that management and equityholders gain by entering the gates of the U.S. private-bargaining regime of Chapter 11.<sup>51</sup> When an auction takes place, *any group* of interest, including creditors, old equityholders or management is subject to the exact same rules of the bidding game as any outside bidder. Put differently, in an auction regime management and equityholders do not gain any personal advantages that other groups of interest would be denied.<sup>52</sup> In an auction regime, commencing reorganization does not provide the old management a safe-haven in which they enjoy the upper hand in negotiations and may stall the proceedings until they are likely to obtain the creditors' concessions and emerge once again at the helm of the corporate

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<sup>48</sup> Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J. L. Econ. & Org. (2001); Baird, *supra* note 1; Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. Rev. 75 (1995); *But see* Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 Ariz. L. Rev. 559 (2001) (arguing that the drafting of the Bankruptcy Code to include muddier rules that leave wide discretion to the bankruptcy judges increases the costs of non-cooperative behavior and thus promotes a cooperative resolution of the debtor's financial distress).

<sup>49</sup> See Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy*, Yale ICF Working Paper No. 04-13 (2004), full text available for download at <http://ssrn.com/abstract=523562>.

<sup>50</sup> See Todd Pulvino, *Do Asset Fire Sales Exist? An Empirical Investigation of Commercial Aircraft Transactions*, 53 J. Fin. 939 (1998). *Cf.* Per Stromberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests*, 55 J. Fin. 2641 (2000).

<sup>51</sup> See Lucian Arye Bechuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J. L. Econ. & Org. 253, 255-6 (1992) (arguing that such distortions include: (a) equityholders' ability to prolong the proceedings and threaten the recovery of the creditors by exposing the firm to additional costs and losses while in bankruptcy, and (b) their extracting value in exchange for foregoing their "option rights" to receive value from the debtor (this "option" exists because the value of the firm remains uncertain as there is no actual realization of assets in reorganization)).

<sup>52</sup> *Cf.* Barry E. Adler & George G. Triantis, *The Aftermath of North LaSalle Street*, 70 U. Cin. L. Rev. 1225, 1233-1238 (2002) (discussing the strong benefits management can enjoy by deviations from absolute priority).

business. Once commenced, the auction regime leads to an open competition among bidders over the control of the firm. It follows, then, that the early decision whether to enter reorganization or liquidation is free of any strategic planning by management and equityholders. Any dilemma, involving genuine business or strategic considerations, is eliminated. The only decision to be made is to enter bankruptcy. What course the bankruptcy case will follow is clear. The corporation will be auctioned, and the *bidders* will determine whether the corporation will be sold as a going-concern or whether its assets will be sold piecemeal. However, it should be noted that the neutralization of private management's benefits in reorganization is not limited exclusively to an auction based bankruptcy regime. Although a *management*-controlled private bargaining reorganization, as Chapter 11, entails the management leverage problem, theoretically a *trustee*-controlled private bargaining regime quashes this problem as well.<sup>53</sup>

## 2. The Homogeneous Options Proposals

One of the more troubling features of bankruptcy bargaining is that it entails a bargaining among divergent groups of claims and interests.<sup>54</sup> Based on their senior or junior priority of distribution, these groups hold heterogeneous interests which are likely to be reflected in their bargaining positions.<sup>55</sup> Arguably, the heterogeneity problem impairs the integrity of bargaining over a bankrupt firm as well as its efficacy. Indeed, in his call for auctions, Baird makes it quite clear that auctions, as a market based valuation system, not only facilitate the allocation of the corporate assets to their most efficient user (the highest bidder), but also separate the question of distribution of the proceeds of the sale among the corporate creditors from the question of future deployment of the assets.<sup>56</sup> Thus, auctions remove the

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<sup>53</sup> See Hahn, *supra* n.35, at 132-133. Cf. David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 Vand. L. Rev. 1325 (1998) (distinguishing between management-displacing and management-controlled bankruptcy regimes).

<sup>54</sup> Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97 (1984).

<sup>55</sup> See Part I.A.1 *supra*.

<sup>56</sup> Baird, *Auctions Revised*, *supra* note 33, at 638. *But see* Sugato Bhattacharyya & Rajdeep Singh, *The Resolution of Bankruptcy by Auction*, 54 J. Fin. Econ. 269 (1999) (criticizing this argument and emphasizing that "each market-based sales mechanism has its own specific distributional attributes, over which different claimants have distinct preferences. Just as current bankruptcy resolution procedures engender claimant conflicts over reorganization plans, the proposed auction-based resolutions, which seek to maintain adherence to APR [absolute priority rule – D.H.], will engender claimant conflicts over specific selling mechanisms." Thus, they assert that "given inherent



heterogeneity problem from the resolution of a bankrupt firm's fate. Other scholars have offered other innovative models for corporate bankruptcy, which are intended primarily to overcome the valuation distortions and heterogeneous interests that are inherent in private bargaining. Mark Roe proposed that a bankrupt firm would issue ten percent (10%) of new common stock through the market and extrapolate its value through this issue.<sup>57</sup> Lucian Bebchuk offered another innovative approach, under which upon bankruptcy the original rights of all existing claimholders and equityholders of the firm would be extinguished. Rather, the senior secured claims would receive in lieu all the equity stake in the firm, while the junior creditors and equityholders would be issued buy-out options. Thereupon, starting with the most junior class (that is, old equityholders) each class would be entitled to exercise its options, under the terms of which the holders may buy out the more senior classes at the value of latter's original claims. Should a class abstain from exercising its option it would lose any stake it had in the firm and the rights would shift to the senior class ranking immediately ahead of the abstaining class.<sup>58</sup> Building on the Bebchuk Proposal, Aghion, Hart and Moore proposed to combine the buy-out options issued to existing claimholders and equityholders with a subsequent vote by the new equityholders (that is, the exercised options) on market bids for the bankrupt firm.<sup>59</sup> Both the Bebchuk Proposal and the AHM Proposal convert all the divergent claims and interests into a newly homogeneous class of equity interests. By so doing these Proposals join Baird's auction model in that they dispense with the heterogeneity problem.

## II. Concentrated Banking and Corporate Financing

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inter-claimant conflict in this regard, it is likely that an independent court can add value to the process, over and above what could be contractually achieved by the affected parties.")

<sup>57</sup> Roe, *supra* note 31 (hereinafter: *The Roe Proposal*) See also Roe, *supra* n.8 (asserting the general preference for market-based regimes).

<sup>58</sup> Bebchuk, *supra* note 22 (hereinafter: *The Bebchuk Proposal*).

<sup>59</sup> Philippe Aghion, Oliver Hart, & John Moore, *The Economics of Bankruptcy Reform*, 8 J. L. Econ. & Org. 523 (1992); Philippe Aghion, Oliver Hart, & John Moore, *Improving Bankruptcy Procedure*, 72 Wash. U. L. Q. 849 (1994) (hereinafter: *The AHM Proposal*). AHM later published an alternative version to their principle proposition. Under the alternate version, the newly issued buy-out options would apply only to former unsecured claims and equityholders, while the old secured claims would remain intact. In addition, an official bankruptcy appointee would be appointed (a trustee or receiver) who would then propose a single reorganization plan to the (new) equityholders of the firm, with no active auction soliciting external bids taking place. Philippe Aghion, Oliver Hart, & John Moore, *Insolvency Reform in the UK: A Revised Proposal*, 11 *Insol. L. & Practice* 4 (1995).

The previous part deliberately assumed that countries around the world operate under similar economic conditions. Thus, the theoretical analysis of the various bankruptcy models disregarded specific idiosyncratic characteristics of specific economies. This part relaxes the homogeneous economies assumption. In particular, it differentiates between economies based on their characteristic channels for financing business firms. The following part will build on the characteristics of certain markets developed in this part and examine which of the various models of bankruptcy law is most compatible for those markets.

### **A. Concentrated Banking Economies**

The structure of local capital markets varies significantly. Certain markets are more developed while others are considered developing. Corporate governance around the world is divergent and, despite an international agenda for reform and implementation of prototypical principles,<sup>60</sup> is largely shaped by the conditions and the characteristics of the particular capital markets in which its rules apply.<sup>61</sup> Economic studies highlight the distinctions between concentrated and dispersed ownership markets.<sup>62</sup> Dispersed ownership markets are capital markets in which, by and large, firms raise capital through an active stock exchange from dispersed investors, ranging from small private investors to large financial institutions. In such markets, the dispersion of investors encourages competition among the financing sources of firms. That is, the basic conditions pertaining to a firm's access to finance are such that it can shop around between different types of investors and different types of financial instruments for its most appropriate package of financing. Yet many small economies around the world lack these attributes.<sup>63</sup> Such economies

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<sup>60</sup> See, e.g., *OECD Principles of Corporate Governance* (2004), <http://www.oecd.org/dataoecd/32/18/31557724.pdf>. For trends of reform within leading OECD members, see *Corporate Governance in OECD Member Countries: Recent Developments and Trends (Revised)* (2000), <http://www.oecd.org/dataoecd/61/2/1932036.pdf>.

<sup>61</sup> See Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 *J. Fin.* 737 (1997); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and Barriers to Global Cross Reference*, in *CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY* 23 (J. McCahery *et al.* ed., Oxford 2002)

<sup>62</sup> Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 *J. Fin.* 471 (1999).

<sup>63</sup> Beck, Demigüç-Kunt and Levine find that poorly developed markets are found primarily in traditional French civil law countries, while traditional common law countries enjoying strong protection of shareholders rights, good accounting regulations and low levels of corruption tend to be more market based countries. Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine, *Law, Endowments and Finance*, 70 *J. Fin Econ* 137 (2003).

often correspond to the concentrated ownership market prototype.<sup>64</sup> Moreover, these markets are characterized by a capital market in which a few financial institutions dominate the supply of finance to the entire local market. Because these financial institutions are often banks, and the capital supply is primarily intermediate debt instruments,<sup>65</sup> these markets are referred to as concentrated banking markets<sup>66</sup> or bank dominated markets.<sup>67</sup> Indeed, there is a strong correlation between concentrated banking and the lack of a well-developed securities market in a given economy.<sup>68</sup>

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<sup>64</sup> The tentative impression from the discussion of various corporate governance regimes might be that it is an issue that is relevant for listed corporations, whose stock is publicly traded through an active stock exchange. Yet, from a normative and policy perspective, the structure of a market's corporate governance bears important ramifications for closely-held corporations as well, as it affects their potential to raise equity capital by going public. See Charles Oman, Steven Fries & Willem Buiter, *Corporate Governance in Developing, Transition and Emerging-Market Economies*, OECD DEVELOPMENT CENTRE Policy Brief No. 23 (2003), <http://www.oecd.org/dataoecd/6/49/28658158.pdf>.

<sup>65</sup> Banks are considered intermediaries between the firms in a market and the capital required for the latter's operations. Correspondingly, bank financing is dubbed intermediate debt, as opposed to bonds and other securities issued by the firm or direct lending by non-bankers – the non-intermediated debt. See Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 Rev. Econ. Stud. 393 (1984).

<sup>66</sup> See Mark J. Roe, *Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10, 44 (1991); Eric J. Gouvin, *Cross-Border Bank Branching Under the NAFTA: Public Choice and the Law of Corporate Groups*, 13 Conn. J. Int'l L. 257, 258 (1999); Arthur E. Wilmarth, *The Potential Risks of Nationwide Consolidation in the Banking Industry: A Reply to Professor Miller*, 77 Iowa L. Rev. 1133, 1143-4 (1992). Cf. Eric J. Gouvin, *Banking in North America: The Triumph of Public Choice over Public Policy*, 32 Cornell Int'l L.J. 1, 3 (1998) (describing concentrated banking markets as "markets in which banking organizations are free to offer a broad range of financial services"); Eric J. Gouvin, *The Political Economy of Canada's "Widely Held" Rule for Large Banks*, 32 Law & Pol'y Int'l Bus. 391 (2001); E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 Iowa L. Rev. 957 (1992).

<sup>67</sup> For a focused comparative study on bank domination in the U.S., Japan and Germany, see Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 Stan. L. Rev. 73 (1995). See also Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 Yale L.J. 1927 (1993) (observing the control of German and Japanese firms by large domestic financial institutions such as the banks through the holding of large blocks of stocks of these firms). For a general empirical comparison between market-based and bank-based financial systems, and the relation between each system and economic development of countries, see Asli Demirguc-Kunt & Ross Levine, *Bank-based and Market-based Financial Systems - Cross-Country Comparisons*, The World Bank Finance Development Research Group, Policy Research Working Paper WPS 2143 (July 1999), available at <http://econ.worldbank.org/docs/323.pdf>.

<sup>68</sup> See, e.g., Amy Chunyan Wu, *PRC's Commercial Banking System: Is Universal Banking a Better Model?*, 37 Colum. J. Transnat'l L. 623, 638 (1999) (stating that "Corporate sectors throughout Asia rely more on bank finance and less on equity than Western markets. China's enterprises are not exceptions.") William L. Horton, Jr. *The Perils of Universal Banking in Central and Eastern Europe*, 35 Va. J. Int'l L. 683, 694 (1995) (describing the limited function the German securities market plays in financing the local private sector as compared to the prevalent bank financing); Skeel & Cheffins, *supra* note 35 (discussing the equilibrium between concentrated equity ownership and concentrated debt markets on one hand, and dispersed equity ownership and dispersed (non-intermediated) debt markets on the other hand); Mark G. Guzman, *Bank Structure, Capital Accumulation and Growth: A Simple Macroeconomic Model*, 16 Econ. Theory 421 (2000).

For a meticulously constructed spreadsheet compiling data from 175 countries around the world concerning, *inter alia*, the relative size of banking activity compared to local securities markets, see

Bank financing provides the lion's share of the total financing in these markets. Thus, the dependency of players in the local commercial activity on bank financing could not be stronger.

### **B. The Efficacy and Perils of Concentrated Banking**

The ubiquity of concentrated banking begs the question whether such a market structure is efficient or rather value-reducing for an economy. Based on data compiled primarily in the U.S., early studies that examined the relationship between concentrated banking and lending efficacy reached conflicting conclusions. For example, Guzman concluded that overall a bank monopoly is liable to lead to credit rationing and manipulate the rates of interest on loans and deposits.<sup>69</sup> Also, Cetorelli argued that strong banking concentration presents entry barriers for entrepreneurs in non-financial sectors.<sup>70</sup> In short, these studies concluded that highly concentrated banking adversely affects the credit market and increases the overall cost of capital. Yet, other studies highlighted the positive effects of concentration on the banks' efficient screening of borrowers' credit profiles and the banks' overall stability. For example, Petersen and Rajan emphasize that in concentrated banking, banks are more likely to assist small firms in financing as the banks develop relationships with those firms and plan on recovering the profits at a later stage.<sup>71</sup> Marquez points to more efficient borrower screening in concentrated banking and the negative effects of information asymmetries and low screening (adverse selection) in dispersed banking.<sup>72</sup> In addition, Beck, Demiguc-Kunt and Levine demonstrate that

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Thorsten Beck, Asli Demirguc-Kunt & Ross Levine, A New Database on Financial Development and Structure, The World Bank Finance Development Research Group, Policy Research Working Paper WPS 2146 (July 1999, as updated 2003), available at [http://www.worldbank.org/research/projects/finstructure/structure\\_database.xls](http://www.worldbank.org/research/projects/finstructure/structure_database.xls); [http://econ.worldbank.org/files/607\\_wps2146.pdf](http://econ.worldbank.org/files/607_wps2146.pdf).

<sup>69</sup> Guzman, *supra* n68 .

<sup>70</sup> Nicola Cetorelli, *Real Effects of Bank Competition*, 36 J. of Money, Credit and Banking 543 (2004). Cf. Sandra E. Black & Phillip E. Strahan, *Entrepreneurship and Bank Credit Availability*, 57 J. Fin. 2807 (2002); Emilia Bonaccorsi di Patti and Giovanni Dell'Ariccia, *Bank Competition and Firm Creation*, International Monetary Fund, Working paper WP/01/21 (2001), available at <http://www.imf.org/external/pubs/ft/wp/2001/wp0121.pdf>.

<sup>71</sup> Mitchell A. Petersen and Raghuram G. Rajan, *The Effect of Credit Markets Competition on Lending Relationship*, 110 Quart. J. Econ. 407 (1995).

<sup>72</sup> Robert Marquez, *Competition, Adverse Selection, and Information Dispersion in the Banking Industry*, 15 Rev. Fin. Stud. 901 (2002). Cf. Tullio Jappelli and Marco Pagano, *Information Sharing in Credit Markets: International Evidence*, R-371 Inter American Development Bank, Research Department, June (1999) (supporting empirically theoretical predictions that information sharing among lending institutions reduces both adverse selection and moral hazard problems and thus improve

concentrated banking contributes to the stability of the banking industry and reduces the risks of a general banking crisis.<sup>73</sup> However, in a recent extensive, global, empirical study, Beck, Demirguc-Kunt and Maksimovic show that overall bank concentration increases financing obstacles and decreases the likelihood of receiving bank finance, with this result proving to be particularly strong in countries with less developed institutions, a small share of foreign-owned banks and a relatively high level of government interference in the banking sector.<sup>74</sup> Similar findings have been recorded by Cetorelli and Strahan, who conclude that concentration of market power by banks presents a significant entry barrier for the entrepreneurial sector of an economy.<sup>75</sup> Nonetheless, Cetorelli has emphasized the basic trade-off inherent in the structure of the banking industry: while more competition is likely to lead to a larger quantity of credit on one hand, accumulation of market power should increase a bank's incentives to produce information on prospective borrowers and lead to higher quality of screening the applicants on the other hand.<sup>76</sup>

With respect to the primary question whether concentrated banking is overall efficient or whether its regressive effects on borrower firms outweigh its economic

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credit availability for borrowers). On the role of banks as information accumulators and efficient monitors for all investors, *see* Diamond, *supra* n. 65.

<sup>73</sup> Thorsten Beck, Asli Demirguc-Kunt and Ross Levine, *Bank Concentration and Crises*, World Bank Policy Research Working Paper No. 3041 (2003), available at [http://econ.worldbank.org/files/26276\\_wps3041.pdf](http://econ.worldbank.org/files/26276_wps3041.pdf) However, they also find that banking regulation which restricts the banking activity solely to the financial sector limits the banks' diversification and thus increases to an extent the overall crisis risk. Nonetheless, the authors find that countries that adopt policies which encourage competition throughout the economy are less likely to suffer from a systemic banking failure. *Cf.* Franklin Allen & Douglas Gale, *Competition and Financial Stability*, (March 24<sup>th</sup>, 2003), available at [http://www.worldbank.org/research/interest/conf/042003/cfs\\_032403.pdf](http://www.worldbank.org/research/interest/conf/042003/cfs_032403.pdf) (demonstrating that the competition-stability trade-off in the structure of the banking industry is applicable in certain situations, but not all).

<sup>74</sup> *See* Thorsten Beck, Asli Demirguc-Kunt and Vojislav Maksimovic, *Bank Competition and Access to Finance: International Evidence*, 36 *J. Money, Credit and Banking* 627 (2004). *Cf.* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Government Ownership of Banks*, (2000), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=236434](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236434) (finding a strong banking concentration in countries whose banking industry is dominated by governmental ownership).

<sup>75</sup> Nicola Cetorelli & Phillip E. Strahan, *Finance as a Barrier to Entry: Bank Competition and Industry Structure in Local U.S. Markets*, NBER Working Paper No. W10832 (October 2004), <http://papers.nber.org/papers/w10832.pdf>; *cf.* Marriane Bertrand, Antoinette Schoar & David Thesmar, *Banking Deregulation and Industry Structure: Evidence from the French Banking Reforms of 1985*, C.E.P.R. Discussion Papers, 4488 (2004), available at <http://www.cepr.org/pubs/dps/DP4488.asp> (finding that distortions in bank lending as a result of the banking structure create artificial barriers to entry in the real sectors of the economy).

<sup>76</sup> Nicola Cetorelli, *Competition among Banks: Good or Bad?*, 2Q *Econ. Persp.*, 38 (2001). *Cf.* Nicola Cetorelli and Pietro F. Peretto, *Oligopoly Banking and Capital Accumulation*, Federal Reserve Bank of Chicago, Working Paper No. 2000-12 (2000); Nicola Cetorelli and Michele Gambera, *Banking Market Structure, Financial Dependence and Growth: International Evidence from Industry Data*, 56 *J. of Fin.* 627 (2001).

benefits this paper takes no assertive position.<sup>77</sup> Rather, it assumes that concentrated banking is a widespread phenomenon that typifies the market structure of many economies throughout the world. Nonetheless, the following part will expose certain adverse effects caused by concentrated banking within the specific context of corporate reorganizations. Even assuming that for certain economies, specifically small ones, the macroeconomic overall account leans in favor of a concentrated banking structure of their market, one ought not to avoid the search for legal measurements which may reduce the adverse effects of concentrated banking.<sup>78</sup> Thus, Part IV will propose the adoption of a reorganization regime which ameliorates the adverse effects of concentrated banking on corporate reorganizations.

### **III. Concentrated Banking and Bankruptcy**

#### **A. Private Bargaining Reorganizations**

The general analysis of private bargaining reorganization regimes in Part I emphasized that its main flaw is the murkiness of the firm's valuation associated therewith. As shown, this distortion undermines the credibility and reliability of private bargaining reorganizations. However, it has also been suggested that the appointment of an external, objective, trustee to control the reorganization negotiations is likely to amend the valuation distortion and enhance the integrity of private bargaining reorganizations.<sup>79</sup>

And yet, a closer examination of a valuation process championed by a trustee reveals the fallacy of a blind reliance on its outcome. The reliability of a trustee-ordered valuation is greatly impaired in concentrated banking markets. That is, in countries where the supply of credit is dominated by few large credit institutions, the trustee is less independent (and hence neutral) than theoretically presumed. Concentrated debt economies suffer from the lack of sufficient competition over corporate financing. As stated earlier, the financing sources of businesses in

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<sup>77</sup> For the general dilemma concerning whether competition or the lack thereof is the superior economic arrangement, see Phillip E. Areeda, *Introduction to Antitrust Economics* 11-14, in *COLLABORATIONS AMONG COMPETITORS – ANTITRUST POLICY AND ECONOMICS* (Eleanor M. Fox & James T. Halverson eds., 1991) (specifically debating the normative justification versus the critique of oligopolies and asserting that the lack of competition alone does not necessarily imply the distortion of optimal production).

<sup>78</sup> See Michal S. Gal, *COMPETITION POLICY FOR SMALL MARKET ECONOMIES* 154-192 (2003) (realizing that for small economies oligopolistic structures might be the economic equilibrium of the market, and thus advocating the regulation of the oligopoly rather than calling for its dismantling altogether).

<sup>79</sup> See Part I.A.2 supra.

concentrated banking economies is predominantly bank lending.<sup>80</sup> The effect of the (few) banks' domination is multifold. First, at the inception of the reorganization case, the banks appear in court as holders of the largest and senior claims and propose their nominee as trustee. Secondly, because the corporation is in dire need of fresh capital to finance its rescue venture, its management will most likely acquiesce to the banks' nominee. As a result of these two factors, it is common practice for the courts to appoint as trustee the banks' and corporation's (common) nominee. In practice, the courts follow the pattern of liquidation cases and appoint lawyers or accountants to fill this role. In small economies the number of experienced practitioners in corporate reorganizations is relatively small. Thus, the trustees are usually repeat players.<sup>81</sup> The banks tend to nominate those practitioners who have best served the banks' interests in previous cases.<sup>82</sup> Thus, it is rather naïve to expect the trustee to exercise a neutral and independent valuation, which may at times upset the bank (as an interested party), when the trustee's appointment in future cases is at stake.<sup>83</sup> For the same reason, neither should one rely enthusiastically on the trustee's negotiations with the banks concerning the restructuring of the latter's debt as representing the best interests of the corporation as a whole. In short, the process of appointing a trustee in reorganization cases does not solve the biased valuation problem.

## **B. Cash Auctions**

At first, the call for implementing an auction regime in corporate bankruptcy appeared to rest on strong theoretical grounds. The economic logic underlying this proposal is clear and simple. However, this proposal assumes the existence of certain economic conditions. Most importantly, it assumes market perfection.<sup>84</sup> Under the

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<sup>80</sup> See supra nn. 65-68 and accompanying text.

<sup>81</sup> For the effect of acting as repeat players in numerous Chapter 11 cases on the law firms representing a debtor and those representing its creditors, see Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125, 156 (1990).

<sup>82</sup> Cf. Vanessa Finch, *Controlling the Insolvency Professionals*, 6 *Insolvency L.J.* 228-239 (1999).

<sup>83</sup> See James J. White, *Death and Resurrection of Secured Credit*, 12 *Am. Bankr. Inst. L. Rev.* 139, 183-184 (2004) (describing a similar phenomenon pertaining to CROs (chief restructuring officers), who are formally appointed by the debtor-in-possession and owe it their loyalty, but effectively – as repeat players in the Chapter 11 practice – place first and foremost the interests of the secured lenders close to their hearts).

<sup>84</sup> Cf. Theodore Eisenberg & Shoichi Tagashira, *Should We Abolish Chapter 11? The Evidence from Japan*, in *CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES* 501, 530 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996) (“Proposals to use auctions or variants thereof in lieu of chapter 11 seem premised on the assumption of a healthy market for troubled large firms (or their

condition of a perfect market, any potential bidder in the auction has no limitation in raising the necessary financing for making the bid. In other words, all bidders have free access to cash. Indeed, the so-called auction approach to bankruptcy is more accurately a *cash* auction approach.<sup>85</sup> It assumes cash money will be placed on the table for purchasing the firm from its creditors and the winning bidder will purchase the corporation free of its old debt. However, as correctly observed by Hart and Aghion, when one assumes away financing market perfection, and introduces cash-constrained bidders as a factor of reality, the efficacy of the bankruptcy cash auction is severely eroded.<sup>86</sup> Commentators acknowledged that where bidders face cash constraints, the good being auctioned may be allocated to the bidder whose financial strength is supreme although that bidder may not be the highest-value user.<sup>87</sup> For example, Shleifer and Vishny point out that the financial distress of a firm may appear during an industry wide financial crisis, in which case the most natural bidders for the firm, its industry counterparts, are cash constrained as well. In such circumstances the number of bidders is likely to be low, which in turn calls into question the benefits of having an auction in the first place.<sup>88</sup> Thus, while the cash auction model for bankruptcy holds for perfect capital markets, imperfections in the supply of cash eradicate the justification for such a regime.<sup>89</sup> In addition, AHM argued that cash

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assets). As firms shrink from the megafirms usually considered in auction proposals, the healthy market assumption becomes more questionable. In samples consisting of small and mid-sized firms, auctions may be of little use"); Skeel, *supra* n.9, at 226 (the law-and-economics proposals for replacing Chapter 11 all depend on the assumption of smoothly functioning markets).

<sup>85</sup> See Thomas H. Jackson, *Comment on Baird, 'Revisiting Auctions in Chapter 11'*, 36 J. L. & Econ. 655 (1993). Cf. Bebchuk, *supra* note 22, 781-786.

<sup>86</sup> See Oliver Hart, *supra* n. 36, at 162; Phillippe Aghion, *Bankruptcy and Its Reform*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 145, 148 (Vol. I, Peter Newman ed., 1998). In a somewhat counterintuitive paper, Rhodes-Kropf and Viswanathan posit that cash auctions in which bidders require financing would prove inefficient even if the financing can be easily obtained through a perfectly competitive financial market. The cause for the inefficiency is the adverse selection problem in the securities market, which cannot effectively separate the valuation of the object being auctioned from the terms of the financing. Matthew Rhodes-Kropf & S. Viswanathan, *Financing Auction Bids*, (2004), full text available for download at <http://ssrn.com/abstract=265150>.

<sup>87</sup> See Yeon-Koo Che & Ian Gale, *Standard Auction with Financially Constrained Bidders*, 65 Rev. Econ. Stud. 1, 3 (1998) ("Actual auctions are full of examples where bidders' financial strength is more important than their valuations in determining the winning bidder ... the good may not be allocated to the highest-valuation user, but may instead go to a better-financed bidder with a lower valuation").

<sup>88</sup> Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. Fin. 1343 (1992).

<sup>89</sup> The market-based reform proposals also seem fit primarily for large and publicly-traded corporations, but fail to account for the bankruptcy of closely-held corporations. See David A. Skeel, *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 Wis. L. Rev. 465 (1993); Lynn M. LoPucki & William C. Whitford, *Corporate Governance and the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. Pa. L. Rev. 669 (1993).



bidders for financially distressed large firms would effectively take the firm private. As a result, the bidder would face a great risk-bearing due to potential future fluctuation in the firm's value. It follows then, that bidders would charge for this risk-bearing by discounting their cash bids, thus frustrating the goal of *ex post* maximization of firm's value.<sup>90</sup>

Nonetheless, an apparent response to the cash constraint objection to cash auctions might be the traditional law-and-economics argument that cash is assumed to be available for actors in the market, either from their own resources or by raising (debt or equity) capital for financing the desired project.<sup>91</sup> In economies where the local equity markets are underdeveloped, for a cash auction bankruptcy regime to be operable the raising of cash would naturally turn the potential bidders to debt financing, and specifically to bank loans. Thus, an analysis of the position of the banks, as the default choice for financing a realistic bid on a financially distressed firm, is critical for assessing the efficacy of the cash auction model for corporate bankruptcy in such economies. Focusing on the interaction between potential bidders for the distressed firm and financing banks, the following sections expose several major obstacles which impede efficient financing of cash bids by banks. The first obstacle is derived from the divergent interests and investment preferences of any bidder on one hand and any bank on the other. The second and third obstacles are a result of the distortions caused by a concentrated banking structure.

### 1. *The Divergent Preferences: Financing Conservatism*

As noted earlier, in concentrated banking markets the channel of equity financing for firms is characteristically underdeveloped.<sup>92</sup> Indeed, in concentrated banking economies the banks are the major suppliers of credit and the overall financing for firms. It follows then, that the banks are often involved in the bankruptcy case not only as a potential financier of bidders, but also as a major creditor of the corporate debtor. In such economies, a bank is invariably a senior

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<sup>90</sup> Based on this weakness, AHM criticize Baird's cash auction model "as too extreme". See Aghion, Hart & Moore (1992), *supra* n.59, at 527.

<sup>91</sup> Margreth Barret, *Merger* by Peter F Harts, 37 Hastings L.J. 1197, 1203 (1986) (Book Review); Lawrence A. Cunningham, *The Essays of Warren Buffet: Lessons for Corporate America*, 19 Cardozo L. Rev 1, 40 (1997) *But see* Richard Schmalensee, *Horizontal Merger Policy: Problems and Changes*, 1 J. Econ. Persp. 41, 47-8 (1987) (noting that it is common sense that if business people believe that cash constraint is an entry barrier, then such perceptions are likely to affect entry decisions, regardless of what economists think of such barriers).

<sup>92</sup> See *supra* Part II. A.

secured creditor.<sup>93</sup> The bank's position as a major secured creditor is likely to affect its discretion whether to finance a bid for the auctioned firm and for what amount. Like every other creditor, the bank is interested in being paid on its prebankruptcy claim. Thus, the bank has a natural self-interest to increase the amount of financing it advances to the bidders, so that the financing will pay off the bank's own claim. In other words, in financing a bid on the firm the bank is effectively paying itself through a process of retiring its preexisting claim by the creation of a new claim. The result of this effect is that to the extent its claim is undersecured, the bank's position as a major secured creditor of the firm drives its financing of a bid on the auctioned firm up towards the amount of the bank's prebankruptcy claim. To illustrate, consider Firm, whose debt to Bank is 100 and its debt to other creditors is also 100. All of Firm's assets are collateralized to Bank through a blanket lien. Firm is in bankruptcy and is being auctioned off. Bidder approaches Bank and asks for cash financing for the purpose of purchasing Firm. Bidder values Firm at 70. Under Bidder's valuation, Bank is undersecured. In such a scenario, Bank is likely to use its influence and persuade Bidder to bid higher.<sup>94</sup> By increasing Bidder's bid to, say, 80 Bank is both improving its own present payback from Firm,<sup>95</sup> and entering a newly negotiated credit of 80 into its own financial statements (that is, refinancing the original loan) rather than listing the old debt as uncollectible debt.<sup>96</sup>

When Bank is oversecured, however, the financing environment is liable to change for Bidder. Assume now that Bidder values Firm at 150 and asks Bank to finance a bid of such amount for Firm. As any lender would act, Bank obviously weighs the Bidder's prospects of timely paying back the loan. This requires Bank to

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<sup>93</sup> Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 Cornell L. Rev. 1396 (1997). Cf. Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 Geo L.J 1 (1997); Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 Harv. L. Rev. 625 (1997) (concerning the mutual choice of bank lenders and borrowers whether to engage in a secured or unsecured credit transaction, in a more balanced and competitive market as the U.S.)

<sup>94</sup> See Bebchuk & Fried, supra n. 30. A classic method Bank may utilize to push Bidder further and increase its bid is to offer Bidder a discounted interest rate for the financing of the increased bid.

<sup>95</sup> Indeed an undersecured bank's self-interest to inflate the financing of a cash bid for the debtor firm is empirically supported by Eckbo and Thorburn. They surveyed Swedish firms that were auctioned in bankruptcy and found that where a bank has an *undersecured* claim, the bank tends to form a coalition with a bidder under which the bank finances bids that drive the price for the firm's assets above their liquidation value. However, this study does not produce conclusive empirical data for financing bids in cases where the bank is *oversecured* by the firm's assets. See Eckbo & Karin S. Thorburn, *Fire-Sales*, supra note 37.

<sup>96</sup> See Eric Grouse, *Banks, Bonds and Risk: The Mycal Bankruptcy and Its Repercussions for the Japanese Bond Market*, 12 Duke J. Comp. & Int'l L. 571, 572 (2002) (noting the reluctance of Japanese banks to sustain losses for bad debts of their borrowing firms and write off those debts).

consider the Bidder's financial stability and its projected use of the credit supplied (that is, its use of Firm), as well as exogenous factors which are likely to affect Bidder's liquidity. Bank computes the risk factor of this particular financing and charges Bidder with an interest rate proportionally. However, as the amount of the financing requested increases there comes a point where the increase of the risk of default outweighs any increase of the feasible interest rate a borrower is capable of handling. Thus, Bank will not necessarily finance Bidder for *any* amount requested. Bank will not risk its money and finance Bidder for 150 even if Bank itself values Firm similarly. Banks are lenders who take precautionary measures to hedge the risks associated with credit. A favorable position for any bank is being an oversecured lender.<sup>97</sup> That is, banks prefer providing credit which is collateralized by a pool of assets the value of which exceeds the amount of credit provided. This equity cushion serves to reduce future risks of default as a result of a substantial increase of the borrower's total liabilities or a devaluation of the borrower's total assets. Thus, returning to the example above, even where Bidder can convince Bank that its valuation of Firm is reasonable, Bank will provide Bidder with actual financing which is lower than 150 to ensure the maintaining of an equity cushion in Firm's assets. An extraction of the above example can illustrate how this can undermine achieving the goal of value maximization. Assume that Bidder B approaches Bank and asks it to finance a bid for Firm for 140 (which is Bidder B's valuation). Assume further that Bank's own valuation is closer to Bidder A (that is, 150), but that Bank prefers leaving an equity cushion of 20 in the collateralized assets (that is, Firm's assets). Thus, Bank is willing to finance bids for Firm by releasing a credit of only 130. In this case, both Bidder A and Bidder B stand on par to gain Bank's credit, even though Bidder A is the highest-valuing user of Firm.<sup>98</sup> It follows then, that once the gap between the

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<sup>97</sup> Mann, *supra* note 93, at 638-658; Jay L. Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795, 851-2 (2004); Jens Hausmann, *The Value of Public-Notice Filing Under Uniform Commercial Code Article 9: A Comparison with the German Legal System of Securities in Personal Property*, 25 Ga. J. Int'l & Comp. 427, 476 (1996); Riz Mokal, *Administration and Administrative Receivership - An Analysis*, 57 Cur. Leg. Stud. 1, 9 (2004).

<sup>98</sup> This intellectual exercise may even take a twist that will cause Bank to *prefer* Bidder B, the lower-value user of Firm. Assume that Bidders A's value, 150, is the weighted average of a 50% probability that Bidder A's control will lead Firm to a value of 220 and a 50% probability that it will lead Firm to a value of 80. Assume further that Bidder B's value, 140, is the weighted average of a 50% probability that Bidder A's control will lead Firm to a value of 180 and a 50% probability that it will lead Firm to a value of 100. In this scenario, Bank is likely to prefer financing Bidder B, despite its inferior use of Firm. Bank is concerned that Bidder A might yield only 80, causing Bank a loss of 20 on its prebankruptcy loan, while financing Bidder B guarantees Bank full payment on this loan. *Cf.*

bidders' valuation and the banks' self-imposed cap on financing is exposed it becomes apparent that the goal of maximizing the value of the debtor firm is unattainable through cash auctions.

The financing conservatism phenomenon is a typical financing approach which banks adopt.<sup>99</sup> The self-imposed cap on the amount a bank is likely to finance is applicable in low- and high competitive banking environments. In underdeveloped equity markets, this natural bank conservatism cannot be off-set by the potential of bidders obtaining financing elsewhere. Because equity financing is barely a viable option in such economies, bank loans rule the financing market. The banks' self-restraint on financing creates a smoke screen through which the signal of the highest-valuing user of the financially distressed firm cannot be amplified and thus received by the selling creditors.

Moreover, in underdeveloped equity markets, the absolute dependency of bidders on bank financing makes the outcome of the auction one which is completely dependent on the *financing bank's* valuation of the auctioned firm, rather than on the *bidder's* valuations.<sup>100</sup> As explained in the preceding paragraphs, a lender cannot be relied on to serve as the efficient screener of the various bidders. Because of its cap on financing, a lender may not necessarily pick the highest-valuing user. Thus, entrusting the screening of cash auction bids and selecting the winning bid exclusively in the hands of the financing bank might fail to obtain this scheme's policy goals. A bank's financing of the auction is liable to curtail efficient value-maximizing competition, as this competition is capped by the bank's lender conservatism.

## 2. *Oligopoly and Conscious Parallelism*

By definition, in a typical concentrated banking market the banking industry in general and the leading dominant banks in particular form an oligopoly.<sup>101</sup> Economists acknowledge that one cannot identify one single prevailing "theory of oligopoly".<sup>102</sup> A prediction of oligopoly behavior in a certain industry cannot be

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David A. Skeel Jr., *The Past, Present and Future of Debtor-In-Possession Financing*, 25 *Cardozo L. Rev.* 1905, 1924 (2004).

<sup>99</sup> Cf. Mann, *supra* n. 93 at 664; Macey & Miller, *supra* note 67, at 77-80; Henry Hansmann & Reinier Kraakman, *Hands-Tying Contracts: Book Publishing, Venture Capital Financing, and Secured Debt*, 8 *J.L. Econ. & Org.* 628, 649 (1992).

<sup>100</sup> Aghion, Hart & Moore (1992), *supra* n.59, at 539.

<sup>101</sup> Joseph A. Schumpeter, *HISTORY OF ECONOMIC ANALYSIS* 305 (1954) relates the origins of the term *oligopoly* to Sir Thomas Moore's *Utopia*, published in 1516.

<sup>102</sup> The classic models of oligopoly are the Cournot Model and the Bertnard Model. See Simon Bishop & Mike Walker, *THE ECONOMICS OF EC COMPETITION LAW: CONCEPTS, APPLICATION AND*

seriously considered reliable unless it is predicated on specific assumptions pertaining to that oligopolistic environment.<sup>103</sup> In this vein, the troubling question in antitrust law has always been when should oligopolies be subjected to legal scrutiny. Should their mere existence subject them to regulative limitations, or need there be some overt act to substantiate a coordinated anticompetitive practice? Traditional antitrust law has particularly targeted explicit agreements which formed organized cartels, but demonstrated a lax approach to covert cooperation among competitors.<sup>104</sup> Nonetheless, in an oligopolistic market the potential for harmful anticompetitive behavior indeed exists one way or the other. Moreover, the penalizing of explicit cartel agreements by antitrust law makes secretive anticompetitive behavior the preferred course of action for potential conspiring oligopolists.<sup>105</sup> But even if oligopolists act independently of one another, and thus apparently non-cooperatively, game theory predicts that given certain conditions the oligopolists will act cooperatively in what is known as conscious parallelism or tacit collusion.<sup>106</sup> That is, each party is acting independently to maximize its own wealth through high-pricing. Yet, consciously predicting a similar high-pricing behavior of its rivals and the parties' interdependence (given the oligopoly structure), then without explicitly receiving or conveying any communication from (or to) them concerning each other's behavior, each party continues its high-pricing. As a result, a cooperative, anticompetitive, equilibrium emerges. Acting on a long term basis, with no certainty as to the time period in which one of the players will remove itself from a certain pattern of behavior, often players participate in an infinite repeated game, or *supergame*.<sup>107</sup> Game theory predicts that the infinite repetition of a game leads to cooperative behavior among the players.<sup>108</sup> However, this general prediction must be

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MEASUREMENT 29-33 (2002); Carl Shapiro, *Theories of Oligopoly Behavior*, in HANDBOOK OF INDUSTRIAL ORGANIZATION 333-352 (Vol. I, Richard Schmalensee & Robert D. Willig eds., 1989).

<sup>103</sup> Shapiro, *id.*

<sup>104</sup> See Richard A. Posner, ANTITRUST LAW 53-55 (2<sup>nd</sup> ed. 2001); Douglas G. Baird, Robert H. Gertner & Randal C. Picker, GAME THEORY AND THE LAW 178 (1994) (explaining that a possible justification for a legal rule, which illegalizes explicit anticompetitive agreements, but which stops short of condemning tacit collusion, "rests ultimately not on the absence of any ability on the part of the firms to engage in tacit collusion, but rather on our inability to do much about it." )

<sup>105</sup> Cf. Posner, *id.* at 52.

<sup>106</sup> See Andrew Dick, *Cartels and Tacit Collusion*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 206 (vol. I, P. Newman ed., 1998) (defining tacit collusion as "coordination among firms that occurs without an explicit agreement").

<sup>107</sup> Eric Rasmusen, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 132 (3d ed., 2001); James W. Friedman, GAME THEORY WITH APPLICATIONS TO ECONOMICS 108 (1990)

<sup>108</sup> Robert Axelrod, THE EVOLUTION OF COOPERATION (1984) demonstrated that such cooperative behavior emerges even between sophisticated players, based on the adoption of a *tit-for-tat* strategy.

qualified, as the high-priced anticompetitive practice of the oligopolists creates incentives for the individual firm to cheat the others, cut its prices below the joint level and generate larger (short-term) profits as the result of its increased (low-priced) sales, despite the future retaliation ramifications the firm will suffer from its counterparts. Thus, tacit collusion equilibria might prove to be fragile and unstable.<sup>109</sup> A cooperative anticompetitive equilibrium is more likely to emerge and remain stable over time given the following limiting conditions to the game: (a) any deviation from cooperation is easily detected and observed by the other parties;<sup>110</sup> (b) the parties can react swiftly to the deviation (*e.g.* adjust prices); and (c) the non-deviating parties can inflict upon the cheater a severe and effective punishment.<sup>111</sup> Detection of deviations from a common practice, coordination and infliction of a penalty on the cheating party is mostly effective as the number of the players in the game is lower.<sup>112</sup> As the number of players increases coordination entails greater

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*See also Baird et al.*, supra n. 104, at 173-174. *But see* Franklin M. Fisher, *Games Economists Play*, 20 RAND J. Econ. 113 (1989) (presenting a skeptical opinion regarding the contribution of academic game-theory to understanding real-life business competition and the restriction thereof. In his closing words: "There is a strong tendency for even the best practitioners to concentrate on the analytically interesting questions rather than on the ones that really matter for the study of real-life industries. The result is often a perfectly fascinating piece of analysis. But so long as the tendency continues, those analyses will remain merely games economists play.")

<sup>109</sup> *See* Alexis Jacquemin & Margaret E. Slade, *Cartels, Collusion, and Horizontal Mergers*, in HANDBOOK OF INDUSTRIAL ORGANIZATION 415, at 420-421 (Vol. I, Richard Schmalensee & Robert D. Willig eds., 1989) ("from the point of view of cartel stability, the more successful firms are at raising price, the greater is the incentive to chisel. A cartel therefore contains the seeds of its own undoing.")

<sup>110</sup> Stigler notes that one's deviation from the joint collusion may be detected by observing a shift of buyers from other sellers to that seller. George J. Stigler, *A Theory of Oligopoly*, 72 J. Political Economy 44, 48 (1964). Jacquemin and Slade note that other effective means of detection are joint gathering of information by the other parties through a joint trade association, the detection of prices which are public knowledge (for example, in the case of an open bid), promising a buyer to match any price-cut offered by a rival firm (and thus revealing secret price-cuts), or observing a *pattern* of sales by one firm. Jacquemin & Slade, supra n. 109, at 421-422.

<sup>111</sup> Baird *et al.*, *id.*, at 174-175. *Cf.* Bishop & Walker, supra n.102, at 151 (explaining that a punishment threat for cheaters is credible when the punishment mechanism is targeted solely on the cheating firm. That is, as a response to a cheater, the other players will not react across-the-board by cheating similarly, but rather invade only the cheater's "territory" for a given time period. "That will allow the other firms to punish the cheater whilst not sacrificing the cartel profits they earn in their own exclusive territories.") Shapiro notes that disciplining the cheater by the other parties might sometimes create a strange outcome: *in order to preserve the collusive practice, the non-cheating parties will (temporarily) increase competition* (for example, by flooding the market with supply and lowering all prices). Shapiro, supra n.102, at p. 357; *Cf.* Edward J. Green & Robert H. Porter, *Noncooperative Collusion under Imperfect Price Information*, 52 *Econometrica* 87 (1984) (listing similar features as characteristic for tacit collusion and arguing, like Shapiro, that market price drops by the joint colluders does not signal the collapse of the collusion but rather is part of its enforcement)).

<sup>112</sup> Baird *et al.*, supra n. 104 at p. 175. Hay and Kelley examined price-fixing cases handled by the U.S. Department of Justice and found that most cases involve ten or fewer firms. G.A. Hay & D. Kelley, *An Empirical Survey of Price Fixing Conspiracies*, 17 J. L. & Econ. 13 (1974) When the number of players is low enough yet exceeds two, the pooling of information by the non-deviating joint colluders makes the detection of the deviation easier and thus even a relatively moderate price-cutting will not pass unnoticed under the other players' radar. Stigler, supra n.110, at 51.

costs and the personal stake of each party in the harm caused by the cheater is smaller. It follows then, that assuming the existence of the aforementioned qualifying conditions, oligopolistic industries with a low number of dominant players are susceptible to anticompetitive cooperative behavior.<sup>113</sup>

As noted in Part II, this article takes concentrated banking as a given, and appreciates that there may be significant virtues in such a structure of the banking industry for certain economies. Nonetheless, in certain respects, the oligopolistic structure of concentrated banking can tag the banks with the label of suspects of tacit collusion. To the extent that tacit collusion by the banks can be deduced from their subtle interests and supported by pointing to the existence of game theory's cooperative facilitating conditions, a legal response is justified albeit not one which calls for restructuring the banking industry lest we throw out the baby with the bath water. The following paragraphs will demonstrate that tacit collusion may indeed be a troubling concern in concentrated banking and highlight the negative effects that bank financing of cash bids for the acquisition of a financially distressed firm might carry as a result thereof. Namely, these negative effects are (a) the direct costs of the banks' credit and (b) the hazard of a systematic squeezing-out of junior creditors.

*a. High-Priced Interest Rates*

Purchasing a firm free of its old debt is no cheap transaction. Usually, the value of paying off the firm's debt is quite significant. For most potential purchasers, requiring a cash payment for the debtor firm necessarily involves raising cash themselves as a prerequisite for placing a bid.<sup>114</sup> In concentrated banking economies this means effectively that a potential bidder must first find a financing bank as its cash source. The banking industry in a concentrated banking economy is effectively comprised of two to three major banks.<sup>115</sup> Even where there are more banks in the industry, these markets often experience a major dominance of a few leading banks

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<sup>113</sup> See Richard A. Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 Stan. L. Rev. 1562, 1565 (1969). *But see* Stigler, *supra* n.110, at 49 (theorizing that concentration alone is not sufficient for establishing tacit collusion, unless additional factors increase the probability of its existence. One such important factor is the relative ease or the lack thereof of the buyers to shift among sellers, notwithstanding the concentrated position of the latter).

<sup>114</sup> *Cf.* Phillippe Aghion, *Bankruptcy and Its Reform*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 145, *supra* n.86, at 146 (vol I, Peter Newman ed., 1998) (noting that one of the two major problems with receivership is that it typically involves a cash sale of the firm, and raising the cash may prove difficult a task in the case of a large corporation).

<sup>115</sup> See the data referenced to in n.116 *infra*.

which enjoy a strong hold over the financing market.<sup>116</sup> Given this strong dominance and the low number of banks active in such markets, the degree of inter-bank competition in concentrated banking economies is relatively low. It follows then that the financing banks are in a classic oligopolistic position. As a result, the financing that potential bidders are seeking is liable to come at a high cost.<sup>117</sup> As oligopolists, the banks may charge prohibitively high interest rates on their loans.<sup>118</sup> Since no other feasible financing sources exist in these markets, potential bidders may face a major financing barrier impeding their intent to bid on the firm. This obstacle decreases the likelihood that the firm will be sold eventually to its most efficient user. As studies have shown, it is more likely that the winning bidder will be the one with better access to bank financing rather than the highest valuing person.<sup>119</sup> In short, while the underlying idea of an auction approach is to use the market by increasing competition over the firm's value and ensuring its placing in the hands of the highest-valuing user, the financing barrier of concentrated banking undermines the very competition that a (cash) auction regime is supposed to facilitate.

#### **b. Squeezing Out Junior Creditors**

Adoption of a cash auction regime in concentrated banking economies is likely to lead to another negative repercussion. As noted earlier, in such economies the financing bank is invariably also the senior secured creditor of the debtor firm. However, there exist other creditors as well. Creditors of a common debtor have

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<sup>116</sup> The World Bank measures the degree of bank concentration based on the assets of the three largest banks in a country as a share of assets of all commercial banks. For the year 2001, of 145 countries surveyed, the average concentration ratio was 0.6115, with the median figure being 0.5969. See Beck, Demirguc-Kunt & Levine, *supra* n. 63, spreadsheet, Column P, available at [http://www.worldbank.org/research/projects/finstructure/structure\\_database.xls](http://www.worldbank.org/research/projects/finstructure/structure_database.xls) Measuring bank concentration by this ratio is reflected also in academic literature. Ongena and Smith find that the overall average number of banks with which a European firm holds relationship is 6, although there exists a great variance among firms from the specific European countries. S. Ongena & D.C. Smith, What Determines the Number of Bank Relationship: Cross Country Evidence, 9 J. of Fin. Intermediation 26 (2000). Dewatripont and Maskin hypothesize that in countries with strong banking concentration, firms will hold on average relationships with fewer banks. M. Dewatripont & E. Maskin, *Credit and Efficiency in Centralized and Decentralized Economies*, 62 Rev. Econ. Stud. 541 (1995)

<sup>117</sup> See John H. Boyd and Gianni De Nicolò, *Bank Risk-Taking and Competition Revisited*, International Monetary Fund Working Paper No. 03/114 (2003) (stressing that banks with greater market power tend to charge higher interest rates on their loans).

<sup>118</sup> Cf., in the U.K., *Competition Commission, A Report on The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises* (Presented to Parliament by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer) (March 2002), available at [http://www.hm-treasury.gov.uk/media/641/E9/competition\\_com\\_bank.pdf](http://www.hm-treasury.gov.uk/media/641/E9/competition_com_bank.pdf).

<sup>119</sup> See *supra* n.87 and accompanying text.



heterogeneous interests.<sup>120</sup> The divergent priorities of the creditors' claims affect the creditors' decision-making. While senior creditors are more apt to promote financial solutions for the debtor which carry a low net present value, junior creditors constantly seek solutions which maximize the debtor's value beyond the bounded horizons of the senior creditor's secured claim. The following paragraph demonstrates that in concentrated banking markets, the banks' domination of the supply side of financing creates a potential hazard of the formation of a bank-bidder coalition to squeeze-out the debtor's junior creditors through a cash auction. To clarify this argument, it will be first assumed that a cash auction takes place in a market with a single monopolist bank. After identifying the interests leading up to the squeeze-out coalition, the monopoly assumption shall be substituted by the more realistic banking structure, that of an oligopoly comprised of few dominant banks. The squeeze-out hazard shall then be analyzed against this state of the banking industry.

### *Monopolistic Banking*

Consider once again Firm, whose secured debt to Bank is 100 and whose debt to Unsecured Creditors is also 100. Now assume Bidder approaches Bank for financing a bid on Firm's assets. Bidder values Firm at 150 and thus asks for financing such a bid. Assume further that Bank, like bidder, values Firm in the hands of Bidder at 150. The Bank contemplates the financing it is willing to advance to Bidder accordingly. It has been shown earlier that in any market, concentrated- and dispersed banking alike, Bank is likely to cap its financing at a figure lower than 150, say 130.<sup>121</sup> However, given now Bank's monopolistic position, it enjoys complete and exclusive control over the auction.<sup>122</sup> Because Bank is the bottleneck through which

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<sup>120</sup> Baird, *supra* note 21, at 79-91; Douglas G. Baird, Thomas H Jackson, Barry E. Adler, *BANKRUPTCY: CASES, PROBLEMS AND MATERIALS* 1-3 (3d. ed. 2000)

<sup>121</sup> *See supra* Part III.B.1.

<sup>122</sup> *Cf.* Stephen J. Lubben, *The New and Improved Chapter 11*, Seton Hall Law School Public Law & Legal Theory Paper Series, Working Paper No. 2 (July 21, 2004), *available at* [http://papers.ssrn.com/paper.taf?abstract\\_id=567321](http://papers.ssrn.com/paper.taf?abstract_id=567321) (discussing the control of a dominant DIP lender over a reorganization case in the U.S. and its distortion of the overall reorganization process, in that it impedes the interests of other creditors). *Cf.* Skeel, *supra* n. 98, at 1921-1926 (noting that the control that DIP lenders gain over the governance of a debtor undergoing Chapter 11 carries the risks of excessive risk-aversion by the controlling lender and undermining value maximization goals through takeout fees charged by the lender. However, plans for post-reorganization business relationships between the debtor and that DIP lender ameliorate the excessive risk-taking peril, and thus also explain the waivers of the takeout fees upon continuation of business between these two parties).

all bids must pass due to all bidders' lack of alternative financing,<sup>123</sup> once Bank has agreed to finance Bidder at a price determined by Bank itself any potential competitor will find the financing barrier as impenetrable. Bank's effective control of the cash auction makes it the sole entity to effectively determine the winning bid.<sup>124</sup> Bank considers its options. For Bank and Bidder, two options are possible:

*Option I* – Bank advances at present financing of 130 for Bidder's bid;

*Option II* – Bank advances at present financing of 100 for Bidder's bid (*i.e.* Stage 1) and reserves the remaining value of 30 for future advances (*i.e.* for Stage 2).

Option I reflects Bank's own (discounted) valuation of the financially distressed debtor under the control of Bidder. Admittedly, Bank plans to generate income on this financing, reflected by the interest rate it charges. If this interest rate is denoted R, then the income the Bank expects to generate is  $R \times 130$ . However, advancing the entire 130 to Bidder at this stage renders the entire corporate enterprise of Firm as fully collateralized. In other words, at the very stage of the bid, Firm's financing capacity is fully exhausted. The financing of Bidder under Option I stifles future financing channels for Firm at a time when it is in dire need of additional funding – upon its emergence from financial distress and return to full scale business activity.<sup>125</sup> Although both Bidder and Bank value Bidder's use of Firm at 150, the tools available for this use are severely restricted by the early exhaustion of the latter's credit capacity. This limitation goes against the mutual interests of Bidder and Bank. Bidder's valuation of Firm cannot be realized without exogenous cash infusions following its acquisition of the control of Firm. The realistic payback to Bank of its financing of Bidder's bid (that is,  $130 \times (1+R)$ ) is predicated primarily on the firm's profits, profits which cannot be gained absent (additional) external financing beyond Bidder's purchase price.

Bank may enhance its own position, though, coincidentally with that of Bidder, by opting for Option II. Under Option II, Bank will advance only 100 for the

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<sup>123</sup> See *supra* Part III.B.

<sup>124</sup> In a similar vein, while analyzing the functions of secured credit, commentators argued that the focus of secured lending is in the *control and strategic power* it gives the lender over the borrower firm's property rather than the potential foreclosure on the collateral. See Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 Mich. L. Rev. 159 (1997); Westbrook, *supra* n. 97.

<sup>125</sup> Upon emergence from bankruptcy, the firm needs cash to pay its employees, new suppliers and similar current expenses, until it can generate sufficient cash-flow from its own business operations. Skeel, *supra* note 35, at 923; Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 Am. Bankr. Inst. L. Rev. 287, 313 (2001); Gregory L. Germain, *Avoiding Phantom Income in Bankruptcy: A Proposal for Reform*, 5 Fla. Tax Rev. 249, 251-3 (2001).

bid.<sup>126</sup> This limitation of the bid serves well both Bidder and Bank. Bidder acquires the control of Firm at a discounted price (compared to its own private valuation) and enjoys an equity cushion of 50 in Firm for future financing. Likewise, Bank enhances its own payback on its original loan to Firm,<sup>127</sup> while simultaneously leaving itself (the monopolist) an equity cushion to serve as collateral for the (near future) jump-start financing Firm will most likely require for its emerging from bankruptcy. Stage 2 of the Bank-Bidder overall financing follows shortly after the acquisition of the control of Firm by Bidder was completed successfully. At this stage, Bank will advance the additional 30 it was willing to advance all along. By bifurcating the overall financing and reserving the 30 to Stage 2, Bank and Bidder join forces in diverting the use of the ultra-Bank-claim value from payout to Unsecured Creditors to financing the post-payout emergence of Firm from bankruptcy. Put differently: The two stage financing allows the jump-start financing to take place from the 101<sup>st</sup> dollar, rather than the 131<sup>st</sup>. While this facilitates Bidder's realization of its value from the use of Firm and improves Bank's probability to collect eventually  $130 \cdot (1+R)$ , this bifurcation comes at the expense of Unsecured Creditors, who are squeezed out in the middle.<sup>128</sup> With respect to the ultra-Bank-claim value of 30, Unsecured Creditors are the true economic sellers. Nonetheless, given the structuring of the financing by the monopolistic Bank they might be deprived of this value in the classic cash auction model.<sup>129</sup>

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<sup>126</sup> Indeed an empirical study of bank lending in the U.K. to financially distressed firms found that the dominant lending banks do not increase their lending nor do they roll-over the loan, but rather tend to contract their financing during the rescue period. See Julian Franks & Oren Sussman, *Financial Distress and Bank Restructuring of Small to Medium Size UK Companies*, CEPR Discussion Paper No. 3915 (2002), available at <http://www.bankofengland.co.uk/conferences/conf0209/franks.pdf>.

<sup>127</sup> In essence, the cash financing of the bid at 100 is a refinancing of Bank's original loan, with the potential legal effect of a shift of the obligor. To the extent Bidder undertakes to repay the bid financing personally, Bank's obligor has changed from the debtor-firm to Bidder. However, if the bid financing was advanced as a secured non-recourse loan, then the refinancing remains within the boundaries of the original obligor (the debtor-firm). Nonetheless, even in the latter case, the underlying assumption of the refinancing is that under the new control of Bidder, the repayment to Bank is facilitated.

<sup>128</sup> A competition between potential bidders may arise, though. However, given Bank's interest in limiting the principal of the auction-financing loan, Bank is likely to channel the competition between bidders to the *interest rate* they are willing to pay over a loan of 100. By limiting the principal of the loan to 100 and developing a competition among bidders over the interest rate, Bank both successfully bifurcates its financing between the two stages and increases its expected return on the loan through the increased, competitive, interest rate. From the perspective of Unsecured Creditors, however, a competition between bidders over the interest rate payable to Bank is of no avail. As long as Bank is successful in limiting the *principal* of the loan to its original claim, the cash bid deprives Unsecured Creditors of their economic stake in Firm.

<sup>129</sup> Cf. Laurent Vilanova, *Bank Seniority and Corporate Debt Restructuring*, (March 12, 2004). EFA 2004 Maastricht Meetings Paper No. 2880, available at <http://ssrn.com/abstract=554602> (noting

### *Oligopolistic Banking*

Setting aside the assumption of a single monopolistic bank, a more realistic analysis must consider the dynamics of the financing of a cash auction in an oligopolistic banking environment. Is the existence of several banks likely to develop an effective competition for financing a cash bid for the control of a financially distressed firm? This paragraph will demonstrate that an affirmative answer to this question is overly-optimistic. In concentrated banking economies, the potential detrimental effect of tacit collusion is substantial particularly in the context of squeeze-out. In the financing market, the oligopolist banks are repeat players in an indefinite supergame. This is likely to lead the banks to cooperative behavior rather than rigorous competition.<sup>130</sup> As a result, the banks might limit the competition over the financing of bids for financially distressed corporations and set the bidding prices for cash auction at the value of the secured lender's (the bank) prebankruptcy claim. That is, given a bank's self interest in limiting the amount of finance in Stage I (the auction) and reserving the remainder for Stage II (post-auction financing), all the oligopolist banks are liable to limit their financing of the auction bids similarly. Indeed, in the short-run, financing a higher bid will allow the deviating bank to sway business from its rivals, but in the long-run this cheating will not pass unpunished. Based on a classic *tit-for-tat* strategy, the cheating bank will suffer corrective retaliation from its rivals who will cheat upon the cheater in future auctions. This facilitates long term anticompetitive cooperation among the rival banks.<sup>131</sup> This anticompetitive behavior comes at the expense of junior creditors, who are squeezed out through the cash auction, as explained above.<sup>132</sup>

It has been shown earlier, that the probability of tacit collusion among oligopolists is highest when deviation from the collusive behavior is easily and quickly detected and the number of participant firms is relatively low.<sup>133</sup> The early detection accelerates the infliction of punishing measures against the deviator. The

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that risk shifting from senior bank lenders to junior creditors occurs even if both types of creditors are equally informed); Franks & Sussman, *supra* n.126 (finding some evidence of opportunistic behavior by senior bank lenders at the expense of trade creditors).

<sup>130</sup> See *supra* Part III.B.2.

<sup>131</sup> Cf. Jacquemin & Slade, *supra* n.109, at 453 (discussing collusive bidding); Dick, *supra* n.106, at 207 (same).

<sup>132</sup> See *supra* Part III.B.2.b.

<sup>133</sup> *Ibid.*

low number of participants facilitates the effective coordination of the penalty. Jacquemin and Slade noted that a readily available detection measure is the observance of prices offered by rivals in an open bid.<sup>134</sup> Where a cash auction is conducted for a bankrupt firm, which is financed by one of the banks, any bid which exceeds the value of the secured lender's (*i.e.* the bank) prebankruptcy claim immediately reveals for the rival banks a deviation by that bidder's financing bid.<sup>135</sup> As for the low number of participants, this is precisely the case in concentrated banking economies.<sup>136</sup>

This tacit collusion hazard is Stiglerianly exacerbated when one acknowledges the limited mobility of bidders from one bank to another in concentrated banking.<sup>137</sup> The literature discussing concentrated banking shows that in such economies customers develop relationship banking activity rather than transaction-based activity.<sup>138</sup> That is, a customer banks primarily with one bank for many years and seldom shifts to another bank.<sup>139</sup> Furthermore, based on data extracted from a survey of Norwegian firms, Ongena *et al.* showed that during periods of crisis the concentration of bank relationship increases, and the use of international banking is cut by fifty percent (50%).<sup>140</sup> This limited mobility fortifies the collusive horizons for the banks. They need not fear defection of long time customers, as the latter are not likely to seek financing for a bid on the distressed firm elsewhere.

Oligopolist banks are thus suspect of a cooperative behavior which facilitates refinancing of their own secured lending through cash auctions while systematically depriving junior unsecured creditors of surplus value they are entitled to under the absolute priority rule. This suspicion severely thwarts the efficacy of cash auctions, as their ultimate goal of value maximization for the creditors is frustrated.

### C. The Homogeneous Options Models

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<sup>134</sup> Jacquemin & Slade, *supra* n.109.

<sup>135</sup> Cf. Marc S. Robinson, *Collusion and the Choice of Auction*, 16 RAND J. Econ. 141 (1985) (arguing that collusive bidding is more likely in open auctions than sealed-bids auctions.)

<sup>136</sup> See *supra* Part II.A.

<sup>137</sup> See Stigler, *supra* n.110, at 48-9.

<sup>138</sup> See Robert Hauswald & Robert Marquez, *Competition and Strategic Focus in Lending Relationships*, (October 2000), available at <http://ssrn.com/abstract=257649>

<sup>139</sup> [http://econ.worldbank.org/files/16574\\_Berger\\_Klapper\\_Udell\\_JBF\\_2001.pdf](http://econ.worldbank.org/files/16574_Berger_Klapper_Udell_JBF_2001.pdf) (Section 2); [http://www1.fee.uva.nl/fm/papers/Awaboot/english/Relationship\\_banking\\_know\\_JFI.pdf](http://www1.fee.uva.nl/fm/papers/Awaboot/english/Relationship_banking_know_JFI.pdf).

<sup>140</sup> Ongena, *supra* n.116

It has been shown earlier that leading scholars introduced innovative models which overcome the heterogeneity problem and purport to channel the resolution of bankruptcy towards a homogeneous decision making regime.<sup>141</sup> However, the common flaw in their models has always been their limited compatibility. To buy out the senior classes under either the Bebchuk Proposal or the AHM Proposal, the holders of the options need the coveted cash. That is, the implementation of either model requires cash, and a significant amount thereof. But, as shown with respect to the cash auction model of bankruptcy, cash is precisely the resource lacking in concentrated banking markets. Thus, these models fall short as far as the latter markets are concerned.<sup>142</sup> However, an interesting model which strives to follow the contours of these Proposals while apparently ameliorating the cash constraint hurdle was proposed by Hart, La Porta Drago, Lopez-de-Silanes and Moore.<sup>143</sup> The HLLM Proposal, as openly declared by its authors, is an improved AHM Proposal. The AHM Proposal calls for a vote of the newly converted equityholders on the bids received for the firm through a market auction. In addition, the HLLM Proposal adds an earlier auction, in which the firm's (old) claimants would be entitled to exercise their reorganization-issued options by selling them to outside purchasers. While HLLM are sensitive to the cash constraint problem and its undermining of the homogeneity driven models of bankruptcy, their own model is also likely to fail in concentrated banking markets. The sale of the newly issued options in itself is subject to a requirement that the outsiders pay *cash* for the rights purchased. If the outside acquirer of these options plans to purchase the entire class of options or the majority thereof, the acquirer will need once again a significant amount of cash. This would reintroduce the cash-constraint barrier, only from the perspective of the outside purchaser rather than from the standpoint of the original option holders. Alternatively, the newly issued options may be acquired on the market by many

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<sup>141</sup> See Part I.B.2 *supra*.

<sup>142</sup> See Alexander Dilger, *The Market is Fairer than Bebchuk's Scheme*, [http://www.rsf.uni-greifswald.de/bwl/pdf/2000/09\\_2000.pdf](http://www.rsf.uni-greifswald.de/bwl/pdf/2000/09_2000.pdf) (2000) (criticizing Bebchuk's options proposal for corporate reorganization *inter alia* because it is unfit for cash constrained junior creditors who cannot exercise the options distributed to them AHM (1992) note and acknowledge that their own proposal entails the use of either cash or non-cash instruments by the outside bidders on the firm, thus ameliorating *the bidders'* financing problem.. See Aghion, Hart & Moore, *supra* n.59, at 539-540. Nonetheless, their proposal suffers, like the Bebchuk Proposal, from the weakness that the *option holders* need cash to first exercise their buy-out options.

<sup>143</sup> Oliver Hart, Rafael La Porta Drago, Florencio Lopez-de-Silanes & John Moore, *A New Bankruptcy Procedure that Uses Multiple Auctions*, NBER Working Paper 6278 (Nov. 1997), available at <http://www.nber.org/papers/w6278> (hereinafter: the HLLM Proposal).

purchasers as small fractions of the overall rights in the firm, with each purchaser investing a minimal amount of cash.<sup>144</sup> However, this assumes the existence of a well developed securities market. It has been shown earlier that in concentrated banking economies such a market is less developed.<sup>145</sup> The trading volume in such markets is relatively small. In addition, even assuming there exists a well functioning market, acquisitions of fractions of the newly issued options may be applicable only for publicly traded firms but not for the closely-held ones.<sup>146</sup> The latter type of firm is found in abundance in concentrated banking markets. In short, these are the flaws which would prove the inapplicability of the HLLM Proposal in concentrated banking markets.<sup>147</sup>

#### **IV. The Proposed Regime: Non-Cash Auctions**

##### **A. The Proposal**

The former part established the reason why adopting a cash auction bankruptcy regime in concentrated banking markets would prove erroneous. Having rejected the basic model of auctions, the question which now looms is what ought to be the appropriate bankruptcy regime for such markets in their stead. One possible model is to readopt the private bargaining regime, under which a reorganization plan is structured through direct negotiations between the debtor and its prebankruptcy creditors. However, it has been shown earlier, that while this model has two variants, either conducting negotiations by the debtor-in-possession (DIP) or by a court appointed trustee, both suffer from significant shortcomings.<sup>148</sup> DIP controlled negotiations have been widely criticized as a process overly biased in favor of management and the equityholders.<sup>149</sup> On the other side of the bias token, trustee controlled negotiations are a dubious fit for small economies with concentrated

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<sup>144</sup> Correlatively, any individual original option holder may opt to exercise the buy-out option with respect to its small fraction of the class of options, by buying-out a *pro rata* portion of the senior claimholders' stake in the firm's (new) equity. See Hart, *supra* n. 36, at 180-181. Indeed, under the HLLM Proposal, the buy-out option may be exercised first internally, by (old) junior claimants, and only afterwards will the cash-out of the newly issued equity rights in the firm be open to external bidding.

<sup>145</sup> See *supra* Part III.B.

<sup>146</sup> See n.89 *supra*.

<sup>147</sup> Hart struggles to argue that the AHM Proposal is applicable also for small corporations, where the junior trade creditors would be entitled to buy-out the senior secured bank creditors. Hart, *supra* n. 36, at 183. However, Hart stops short of convincingly explaining from where exactly would the trade creditors generate the necessary cash for exercising this buy out option.

<sup>148</sup> See *supra* Part III.A..

<sup>149</sup> Bradley & Rosenzweig, *supra* note 17; Roe, *supra* note 31, 533; D. Hahn, *supra* n. 35 (limiting the critique of DIP controlled regimes particularly to equity ownership concentrated markets).

banking due to the trustee's strong and longtime economic ties with the dominating creditors.<sup>150</sup> Thus, bankruptcy cases of firms in concentrated banking markets merit a different mechanism for resolving those firms' financial distress and paying off their creditors.

In my opinion, any resolution must first conform to the legal and cultural tradition of the country in question.<sup>151</sup> It must be a receptive model, easily implemented by the legal practice.<sup>152</sup> As Mark Roe correctly noted, in a free capitalistic society certain inefficient legal structures may endure more than efficient alternatives to the extent that they are more feasible politically.<sup>153</sup> Attempting to employ a model which is simplistic and traditionalist enough on one hand, yet responsive to the character of concentrated banking economies on the other hand, I propose that such markets hold an open *non-cash* auction of the debtor firm. Like cash auctions, non-cash auctions are public and open to any prospective bidder. However, the consideration a bidder must offer in a non-cash auction differs significantly from that required under a cash auction procedure. In non-cash auctions, a bidder may offer to pay off the firm's prebankruptcy claims through an economic package containing any combination of payment instruments. The payment may include some cash, but also the issuance of new debt instruments to the old creditors, payable in installments. Alternatively, the bidder may offer new equity shares in the debtor firm in exchange for the creditors' prebankruptcy claims.<sup>154</sup> Be the consideration paid in a non-cash auction as it may, a common denominator is shared by all *non-cash bidders*: to some extent, they all *rely*

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<sup>150</sup> See III.A *supra*.

<sup>151</sup> Sensitive to economic and political traditions, Manfred Balz, an experienced German bankruptcy scholar, proposed that countries from Central and Eastern Europe, Asia and Latin America adopt an auction mechanism for financially distressed corporations, which would offer to hold either an asset type auction or an equity type auction. These countries have little experience with market mechanisms, low standards of accounting, and inadequately educated and poorly paid judges. In his opinion, such countries are less suited to adopt a complex bargaining-based reorganization regime. Manfred Balz, *Equity Auctions and a New Concept of Priority: Two Bankruptcy Reform Proposals*, (March 1, 2001) [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=264511](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=264511).

<sup>152</sup> Cf. Easterbrook, *supra* n46 .

<sup>153</sup> Roe, *Backlash*, *supra* n. 8 at 236-237. Applying this general observation to the specific context of corporate reorganizations, *inter alia*, he thus states as follows: "it is hard to see how secondary political effects can be eliminated from the efficiency inquiry. One can believe in the stand-alone efficiency of this or that institution (free-wheeling hostile takeovers, chapter 11 sales of public companies) and still doubt whether their persistence will maximize political efficiency. The dampening rules may enhance a system's adaptivity and stability, preserving the core efficiency tendencies of capitalism, private property, and competitive markets, by conceding a few economically unwise but politically astute regulations here and there." *Id.*, at 237.

<sup>154</sup> See Hart, *supra* n. 36 at 171. Rhodes-Kropf and Viswanathan find that in non-cash auctions the use of debt instruments signals to the sellers more informatively the quality of a bidder as compared to equity instruments. See Matthew Rhodes-Kropf & S. Viswanathan, *Corporate Reorganizations and Non-Cash Auctions*, 40 J. Fin. 1807 (2000).



on the future performance of the acquired debtor firm as a means for paying off prebankruptcy claims. In the case of installment payments, the bidder plans to pay the claimants out of the firm's future revenues. Equity instruments issued in an equity-for-debt exchange also derive their value from the firm's future performance.

Effectively, a non-cash auction bankruptcy regime would operate as an improved and perfected *La Salle* approach to corporate bankruptcy. Under the U.S. Supreme Court holding in *La Salle*,<sup>155</sup> whenever a debtor-in-possession proposes a reorganization plan which distributes value to the equityholders without first fully paying the creditors and that plan fails to receive the approving vote of all the classes of creditors, Chapter 11's exclusivity period<sup>156</sup> is terminated and the proposed plan is exposed to the introduction of competing plans. Essentially, *La Salle* mandates choosing among competing plans only if the initial plan proposed allocates value to the old equityholders. The non-cash auction bankruptcy regime, on the other hand, would facilitate the introduction of such competing plans *ab initio*, in every corporate bankruptcy case. Non-cash auctions reject the initial advantage which management and equityholders hold under Chapter 11. No party enjoys an exclusivity period regarding the reorganization plan. The resolution stage is open for all actors in the market, old claimants and equityholders as well as newcomers, each enjoying an equal footing in the firm's bankruptcy case.

## **B. Maximizing Firm's Value**

The different consideration used in cash and non-cash auctions is the key to evaluating the aptness of either to specific economic markets. In the case of concentrated banking markets, the major obstacle associated with *cash* auctions identified earlier was the powerful position oligopolistic banks hold as the sole realistic financiers of a bid for the firm. This position adversely affects the auction in that it frustrates potentially wealth maximizing bids.<sup>157</sup> By contrast, non-cash bids carry the potential of facilitating such bids. The lure of *non-cash bids* in the context of concentrated banking markets is that bids *can be placed* on the debtor firm independently, *without the bidder having to obtain bank financing as a prerequisite*. The disengagement of bidders from the dominating banks would significantly

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<sup>155</sup> *La Salle*, *supra* note 18.

<sup>156</sup> Under § 1121(b) of the Bankruptcy Code the debtor enjoys a 120-day exclusivity period during which it is the only entity entitled to file a reorganization plan with the court.

<sup>157</sup> See Part III.B.1 *supra*.

improve the mechanism of a public auction of the firm. Compared to cash auctions, in non-cash auctions more bidders can practicably bid on the firm. Thus, a true competition over the debtor firm, the core of auction theory, would be perfected.<sup>158</sup> With more bids being placed on the firm, a reliable market-based valuation may be extracted from the auction procedure. Indeed, each bid would likely reflect the *bidder's* valuation of the debtor firm, not the bank's.<sup>159</sup> In short, to the extent it is a market based valuation of the firm one seeks in bankruptcy, in concentrated banking markets that valuation is more likely to be generated through a non-cash auction procedure rather than through a cash auction.

Correlatively, releasing bidders from the financing cords of the dominating banks allows new entities to place bids which maximize value to the debtor firm's creditors. Compared to the private bargaining model of bankruptcy, non-cash auctions promote exogenous resolutions of a firm's financial distress rather than limiting the solutions to the firm's prebankruptcy actors.<sup>160</sup> Consistent with auction theory, widening the circle of potential participants facilitates reaching the goal of maximizing the firm's value.<sup>161</sup>

### **C. Modifying Creditors' Legal Rights**

Holding a non-cash auction allows the parties to enjoy a market valuation of the corporation. However, unlike cash auctions, in non-cash auctions the determination of that market valuation is itself subject to further analysis. Indeed, one of the more appealing features of a cash auction regime is the certainty and finality of the distribution to the creditors. In a cash auction, the firm's assets are realized and the actual cash proceeds are distributed to the creditors based on their respective priority. No speculations and estimations need to be made concerning the firm's value and no underlying assumptions remain relevant any longer. A cash auction renders any negotiations between the auctioneer and the firm's creditors obsolete. The distribution

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<sup>158</sup> See Part III.B *supra*.

<sup>159</sup> See AHM, *supra* n59, at 856-7.

<sup>160</sup> But see Elazar Berkovitch, Ronen Israel & Jaime F. Zender, *The Design of Bankruptcy Law: A Case for Management Bias in Bankruptcy Reorganizations*, 33 J. Fin. & Quantitative Analysis 441 (1998) (defending limited auctions bankruptcy regimes, in which only a firm's prebankruptcy creditors and management would be eligible to place bids for the control of the firm, and further encouraging a favorable treatment of management in bankruptcy as a means for obtaining improved prebankruptcy managerial services in the firm).

<sup>161</sup> In this vein, Bruce Markell supported allowing prebankruptcy equityholders to participate in the bid. Moreover, Markell reasoned that the equityholders possess superior information concerning the debtor firm and thus their participation in the bidding releases that information (through the price) to other bidders as well. See Markell, *supra* note 27.

to the creditors shall be determined exclusively by the amount of the highest cash bid. In essence, a cash auction regime shares proximate attributes with a straight-forward liquidation procedure.<sup>162</sup>

Conversely, in a non-cash auction no specified cash is placed on the table for distribution to the firm's prebankruptcy creditors upon the announcement of the winning bid. Rather, the payment is based on the firm's *future* performance. This entails that differentiating one bid from another cannot be based simply on a bidder's self assigned dollar value of its bid. Several parameters affect the true economic value of a bid. The total period of time during which the installment payments are due as well as the interest rate they bear, the nature of the future business of the firm once a bid is accepted, and the security and guarantees the bidder is proposing to back the deferred payments may all vary from one bidder to another. These variables need to be considered in connection with valuing a non-cash bid. In addition, the managerial skills of each bidder play a major role in weighing their respective bids.<sup>163</sup> In other words, from the creditors' perspective the actual satisfaction of their legal claims is postponed further into the future. In a manner which in this respect (and this respect only) is somewhat reminiscent of privately-bargained reorganizations, the creditors remain as claimants or equityholders of the corporation beyond the immediate horizon of the reorganization case. The creditors' claims are yet to be satisfied. Unlike a cash auction, which involves the actual realization of the firm's assets, the ensuing distribution of the proceeds to the creditors and the termination of all debtor-creditors legal relationships, a non-cash auction requires the creditors to exchange one set of legal rights relating to the firm (the prebankruptcy claims) with another. In the legal sense, non-cash bids potentially modify the creditors' claims in several ways. First, one must ascertain whether the present value of a bid is equal to the creditors' prebankruptcy total amount of claims or smaller. Secondly, even if the present value of a bid is equal to the value of the prebankruptcy claims, modifying the payment period in itself, although compensated through the interest promised to be paid thereupon, alters the original legal rights of those creditors. Finally, issuing equity interests in lieu of the creditors' claims alters completely the nature of the

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<sup>162</sup> Baird, *Uneasy Case*, *supra* n.3, at 638-641; Jackson, *supra* n. 85, at 665-667

<sup>163</sup> See Rhodes-Kropf & Viswanathan, *supra* n154, at 1809.

creditors' rights in that it turns them from creditors to shareholders.<sup>164</sup> From the legal perspective, the modification of creditors' rights in non-cash auctions requires holding a vote on the bids. It follows then, that *non-cash auctions should be completed through a vote taking place once all the bids have been placed*. Indeed, the economic preference of the relevant stakeholders must be voiced through their voting for the superior bid as they deem it. Thus, a non-cash auction bankruptcy regime should follow the *procedural* steps of existing private-negotiations bankruptcy regimes. Although they differ in economic substance, that is non-cash auctions facilitate market based bids for the firm while privately negotiated reorganization plans facilitate solely the concrete proponent's bid, both regimes ought to share the same legal procedure for officially approving the chosen reorganization plan.

In a non-cash auction, voting by creditors on the various bids entails a collective decision-making which involves divergent creditors with heterogeneous interests. It has been noted earlier that the heterogeneity problem casts a shadow over the integrity and efficacy of the private-bargaining bankruptcy prototype.<sup>165</sup> Unlike private-bargaining, non-cash auctions enjoy a competitive atmosphere and an openness of the procedure to any interested participant. Thus, gaining bargaining leverage and distorting the terms of the reorganization plan, the cons of private-bargaining, would not impede the integrity of non-cash auctions. Nonetheless, collective voting on the competing bids by classes of creditors cannot avoid the heterogeneity phenomenon. Indeed, the involvement of divergent interests of creditors and equityholders in the bankruptcy proceeding is an inherent derivative of the law which confers priority on some creditors while denies such benefits to the others.<sup>166</sup> As long as the priority system is justified and rests on sound legal policy, the heterogeneity phenomenon should be accepted as part of the rules of the game. In Part III it has been shown that the drive towards a homogeneous-interests bankruptcy regime appears to be utopian. Reality proves that concentrated banking markets necessitate a heterogeneous-

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<sup>164</sup> Cf. Bankruptcy Code § 1124 (providing that any alteration of the legal, equitable and contractual rights to which a claimant is entitled renders that claim as impaired).

<sup>165</sup> See Part III.A *supra*.

<sup>166</sup> The rationales for according priority to secured creditors while denying a preferable treatment from unsecured creditors have been analyzed at length in the literature. For a concise summary of the leading theories justifying the seniority of secured credit see Barry E. Adler, *Secured Credit Contracts*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 405-410 (vol. III, P. Newman ed., 1998).

interests bankruptcy regime. Among such potential regimes, the non-cash auction regime proves superior.<sup>167</sup>

#### **D. Enhancing Collective Decision Making**

Voting on the competing bids in a non-cash auction allows *all* old creditors of the debtor firm to opine on each bid and to declare the one mostly favored by them. In concentrated banking economies, a creditors' voting necessarily means (re)turning to the voice of the dominating bank. As explained, that bank is invariably the senior secured prebankruptcy creditor of the debtor firm.<sup>168</sup> Thus, an encounter between a bidder and the dominating bank is unavoidable. This eventual encounter begs the question: what then has been gained by utilizing non-cash auctions? The underlying rationale of preferring non-cash auctions is to facilitate bids that are independent of bank financing and the banks' ultimate control.<sup>169</sup> But this rationale seems to be completely eroded by the banks' effective influence over the outcome of the auction in their capacity as senior creditors. In other words, what non-cash auctions seem to successfully avoid apparently backfires as the banks, in their capacity as prebankruptcy creditors of the debtor firm, vote on the actual non-cash bids. And yet, this is not the case. Non-cash auctions can make a difference and enhance an auction resolution of financial distress. A vote on non-cash auction bids is more complex than straight forward cash bids financed by a bank. Financing a cash bid effectively makes the bank the *sole* decider of the actual winning bid and the value available for distribution to the creditors as a result thereof.<sup>170</sup> By contrast, in non-cash auctions, the bank is *one of a whole group* of creditors voting on the bids made. Obviously, as a creditor of the firm the bank is entitled to voice its opinion on a modification of its rights. But so do the other creditors. Realistically, considering the bank's position as the major supplier of credit and the collateral securing its claim, the bank has a significant and influential position within the framework of the voting process. However, other creditors, whose claims are also at stake in the bankruptcy of the

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<sup>167</sup> My heterogeneous interests voting on non-cash bids shares the views expressed in both the AHM Proposal and HLLM Proposal that non-cash bids for the firm enhances value maximization of the firm compared to cash auctions, but part ways from these Proposals concerning the capital structure of the reorganizing firm prior to voting on the bids received. While these proposals envisage an all equity (or, in the lexicon of HLLM: Reorganization Rights) firm, my proposal follows the prebankruptcy combination of debt and equity structure of the firm's capital.

<sup>168</sup> See Part III.B.1 *supra*.

<sup>169</sup> See Part IV.A *supra*.

<sup>170</sup> See AHM, *supra* n. 59, at 871.

common debtor firm, voice their opinions on the various bids as well. In a *non-cash auction*, the winning bid is determined by a democratic process, which *gives appropriate weight to all relevant claims, not just the bank's senior claim*. The voting process counterbalances the bank's market advantage by imposing a legal proceeding which induces a *collective* decision rather than a dictation of a result which is most convenient for the bank's own interests.<sup>171</sup>

Voting on non-cash auctions enjoys the virtue of a collective decision-making. To implement this ideal practically, though, the voting procedure taking place in a non-cash auction regime must be one which negates a *de facto* absolute control of the voting outcome by any single creditor in general and the dominating bank in particular. Because their interests are in conflict with one another, as a result of their divergent distributive priorities, different creditors are classified separately and vote within classes.<sup>172</sup> Secured creditors are classified separately.<sup>173</sup> Analytically, each secured creditor constitutes a class of its own, based on its unique and specific interest in the firm's assets. By contrast, unsecured creditors are usually classified together in a single class.<sup>174</sup> It follows, then, that to achieve the collective decision-making goal, any law implementing a non-cash auction bankruptcy regime must overcome the potential veto power the banks may possess through their separate classification. Overcoming a veto vote may be accomplished through a prototypical cram-down provision.<sup>175</sup> To be sure, cram-down is no absolute priority rule negating measure.<sup>176</sup> The non-cash auction regime would follow the conventional APR distribution order.

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<sup>171</sup> For the distortions caused by allowing the banks to effectively serve as the sole decision makers on bids for the firm, *see* Part III.B.2 *supra*.

<sup>172</sup> 7-1122 Collier on Bankruptcy - 15th Edition Revised P 1122.03 (2004) ; Bruce A. Markell, *Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 Bank. Dev. J. 1, 15-17 (1994/1995); Scott F. Norberg, *Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification*, 69 Am. Bankr. L.J. 119, 119-120 (1995)

<sup>173</sup> Thomas C. Given & Linda J. Philipps, *Equality in the Eye of the Beholder -- Classification of Claims and Interests in Chapter 11 Reorganizations*, 43 Ohio St. L.J. 735, 757 (1982) ; Scott F. Norberg, *An Analysis of Developments in Bankruptcy Law: The National Bankruptcy Review Commission's Recommendation on Classification of Claims in Chapter 11*, 18 Miss. C. L. Rev. 411, 413 (1998)

<sup>174</sup> Norberg, *Id* ; Norberg, *supra* note 172.

<sup>175</sup> Cf. Bankruptcy Code § 1129(b). Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 Emory L.J. 1009, 1037 (1987); David A. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After Ahlers*, 63 Am. Bankr. L.J. 221, 222 (1989)

<sup>176</sup> Under current U.S. law, commentators have pointed to the *stalling* tactics that junior claimants and equityholders may employ, as well as to the (pre *La Salle*) management's *exclusivity* right to propose a plan, even when it distributes value to old equityholders under the "new value" exception, as the main concerns for deviation from the absolute priority rule. *See*. Lopucki & Whitford, *supra* n.81, at 184; Adler & Triantis, *supra* n.52.

The cram-down provision would simply serve as a supplementary judicially directed mechanism, aimed at ameliorating the absolute control over the determination of the winning bid that the concentrated banks would otherwise obtain. Cram-down would allow the other creditors to bring to the fore, through a judicial proceeding, a competing bid, which the banks have ruled out (through their class vote) as "too risky". The cram-down provision is a countervailing measure to the banks' ultimate control over the auction's outcome. It is not meant to bypass the banks' vote, only to subject that vote to a judicial check.<sup>177</sup> Given the perils that concentrated banking causes in corporate bankruptcy, this check is a necessary measure to complement the non-cash auction solution.

### **E. Subtle Antitrust Measures**

Despite working within the context of bankruptcy and thus affecting directly creditors' rights, non-cash auctions may also serve a broader cause. Such auctions also may be considered a fine measure for combating the perils of tacit collusion in concentrated banking. It has been noted earlier that a major limitation for enforcing antitrust law is the costs of detection of anticompetitive practices. This is the reason that explicit cartels are invariably regulated while tacit collusions are somewhat beyond the scope of antitrust law.<sup>178</sup> In addition, even where the anticompetitive practice is detected the enforcement of antitrust law measures entails costly actions, such as lawsuits and continuous monitoring of the colluding parties.<sup>179</sup> Employing subtle competition enhancing measures through other fields of law may prove a positive complement to antitrust law in its attempt to combat anticompetitive measures such as tacit collusions. Thus, when the law can overcome an anticompetitive measure by adopting alternative mechanisms which obviate the dependency on the oligopolists' services, antitrust policy is served. Such alternative measures operate at a low cost. They encourage economic competition rather than

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<sup>177</sup> Several commentators noted that provisions that deny either party an absolute control over the outcome of a negotiated process carry the positive potential of enhancing productive and consensual outcomes rather than contested one. *See, e.g.*, Lucian A. Bebchuk, *Chapter 11*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 219, 220-221 (vol. I, P. Newman ed., 1998); Janger, *supra* n.48; Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 *Am. Bankr. L.J.* 69 (1986); Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 *Bus. Law.* 441 (1984).

<sup>178</sup> *See* n.104 *supra*.

<sup>179</sup> Warren F. Schwartz, *An Overview of the Economics of Antitrust Enforcement*, 68 *Geo. L.J.* 1075 (1980); A. Mitchell Polinsky, *Detrebling versus Decoupling Antitrust Damages: Lessons from the Theory of Enforcement*, 74 *Geo. L.J.* 1231 (1986)

walk the legal path of detecting anticompetitive practice and enforcing penalizing measures thereagainst. Non-cash auctions exemplify such subtle antitrust measures. They are a classic illustration of implementing antitrust policy through bankruptcy law measures.<sup>180</sup> Obviously, achieving the antitrust goals is secondary to meeting the primary concerns of bankruptcy law itself. However, once it has been demonstrated that non-cash auctions facilitate the maximization of value to the firm's creditors, serving antitrust policy blends integrally with meeting bankruptcy law's own goals.

## CONCLUSION

This article addressed the normative approach to bankruptcy law. The question which bankruptcy law model is optimal has occupied the academic literature for many years now. Yet, the various models suggested by leading authorities in this field were mostly planted in U.S. grounds. The literature has largely disregarded the various factors which separate different economic regimes. Countries around the world differ in their economic structure. The financial conditions of a country like the U.S. may facilitate effective competition over the financing of market activities, but in other countries such competition barely exists. The article tackled the issue of countries where effective competition over financing is hardly existent and the ramifications of such financial constraints on the resolution of corporate bankruptcy. The article approached the phenomenon of concentrated banking economies as a given structure of many economies around the world. It showed, however, that even one who considers concentrated banking as overall efficient cannot ignore the concrete hazardous ramifications which concentrated banking holds for financing cash bids for distressed firms. This article established the anticompetitive measures which oligopolistic banks are likely to use to frustrate value-maximizing cash bids. The banks are suspects of unilaterally imposing caps on their financing of any potential cash bid for the firm, caps which *inter alia* are a function of those banks' prebankruptcy senior secured claims. The cash constraint problem from which players in concentrated banking economies suffer is exacerbated by the corresponding

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<sup>180</sup> It is common to find lawmakers influencing the practice in a certain field of law by planting carrots or sticks in another field. The classic field of law utilized for the creation of incentives to practice the law in a certain way favored by the lawmakers is taxation. *See* S. S. Surrey & P. McDaniel, TAX EXPENDITURES, 99-117 (Cambridge, 1985); John G. Steinkamp, *A Case for Federal Transfer Taxation*, 55 Ark. L. Rev. 1, 28-31 (2002); Kurt Hartmann, *The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control Through The Federal Tax Code*, 6 DePaul Bus. L.J. 159 (1994).



underdevelopment of local stock markets in such economies. Thus, when Douglas Baird has called for implementing a *cash* auction bankruptcy regime he clearly did not have concentrated banking economies in mind. When bidders lack the requisite cash, and their only source for obtaining it is an oligopoly group of banks, the cash auction will fail to promote the goal of efficiency. Baird's proposal is simply inadequate for such economies. Likewise, the innovative bankruptcy proposals of Bebchuk, AHM and HLLM, all of which call for converting the prebankruptcy rights of creditors and shareholders to newly issued options to buy out the firm's equity rights, also fall short due to the lack of available cash for exercising the buy-out options or for acquiring those rights through the market.

In view of the incompatibility of these cash consuming, market oriented, models of corporate bankruptcy this article proposed to adopt an alternative market oriented bankruptcy model. It proposed employing a non-cash auction regime, under which bidders would be encouraged to bid for the control of the firm while reducing the bidders' dependency on bank financing. Cutting the Gordian knot between all bidders and bank financing is essential for facilitating efficient market-based bankruptcies in concentrated banking economies. The outcome of a non-cash auction would be determined by a vote of the various classes of claimants, in a manner similar to the current procedure of U.S. Chapter 11. Effectively, this model would prove to be a perfected *La Salle* bankruptcy scheme. In all bankruptcy cases, internal and external bidding would be invited, thus ensuring a healthy competition which would maximize the *ex post* value of the firm, to the benefit of all claimants.