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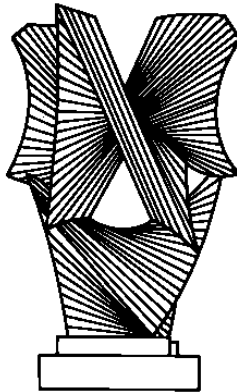
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Chapter 11 at Twilight

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Chapter 11 at Twilight

Douglas G. Baird* and Robert K. Rasmussen**

Abstract

In *The End of Bankruptcy* we set out the forces that have rendered obsolete traditional conceptions of corporate reorganization. Lynn LoPucki wrote a critique that asserted that our paper lacked empirical foundation. In this response, we draw on LoPucki's data set of the reorganization of large, publicly held entities to show the robustness of our claims, both empirical and theoretical.

Looking in detail at the firms whose Chapter 11 cases ended in 2002, most of which concluded after we completed our original piece, we find that in over 80% of the cases the assets of the firm were either sold or the bankruptcy proceeding put in place a restructuring plan agreed to before bankruptcy was filed. The remaining firms evince little in the way of going-concern value. Moreover, equityholders are nearly always wiped out, and the board of directors is usually replaced.

Today's bankruptcy practice reveals creditors, particularly the senior lenders, in control. They use their powers to remove managers in whom they have lost confidence, replace the board of directors, put the corporation on the auction block and terminate the interest of equityholders. This paper provides further evidence that issues of control rather than priority dominate modern reorganization practice.

In *The End of Bankruptcy* we showed that a number of forces – increasing standardization in the economy, more liquid capital markets, the ability to sell entire companies in bankruptcy, and modern lending practices – render obsolete the traditional conception of Chapter 11. It is no longer a forum in which creditors, shareholders, and boards negotiate over a corporation's future. Instead, it has become a place where creditors orches-

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First, we wish to thank Lynn LoPucki. In addition to posing a number of interesting questions that have required us to sharpen our own ideas, he has, with characteristic graciousness, provided us with access to the large database of Chapter 11 reorganizations that he has assembled painstakingly over the course of many years, a database that has already yielded rich insights. We also thank Ronald Mann for his comments on a prior draft of this response, Bethany Hollister for research assistance, as well as Visa, U.S.A., Inc., Verizon, Microsoft Corporation, the Sarah Scaife Foundation, and the Lynde and Harry Bradley Foundation and the Dean's Fund at Vanderbilt for research support.

trate the sale of the business or where they implement a deal negotiated outside of bankruptcy.

The dramatic nature of this change is plain enough.¹ During the 1980s, nearly 9 out of every 10 large businesses entered Chapter 11 without a prenegotiated plan and emerged intact.² By 2002, they numbered fewer than one in four. And the transformation goes beyond the numbers. Even among the quarter of cases that might appear to be traditional reorganizations, much has changed. Equityholders are wiped out in Chapter 11 today.³ New investors take control, replace the old board, close plants, and move production offshore. Even in the businesses that look most like traditional corporate reorganizations, little in the way of going-concern value is preserved.

¹ Since the publication of *The End of Bankruptcy*, others (including some whose views of bankruptcy are radically different from ours) have acknowledged the extent of these changes. Harvey Miller and Shai Waisman agree that the economy has fundamentally changed businesses and that Chapter 11 should no longer be seen as preserving old economy manufacturers. They also agree that creditors now have much more control. Nevertheless, they believe that we have overstated the role that markets can play and understated the extent to which Chapter 11 is needed to solve collective action problems. See Harvey R. Miller & Shai Waisman, *The Erosion of Debtor Protections in the Face of Expanding Creditors Rights and Control* (NYU Workshop on Bankruptcy and Business Reorganizations, September 2003).

Elizabeth Warren and Jay Westbrook also note that creditors are now often in control of the Chapter 11 process and have dramatically transformed it: “We have a new form of chapter 11 emerging in the courts. Having invented the DIP (debtor-in-possession), American lawyers are now creating the SPIP (secured-party-in-possession). More and more chapter 11 cases seem to be no more than vehicles through which secured parties may enjoy their Article 9 rights under the umbrella, and protective shield, of the bankruptcy laws.” See Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 *Am. Bankr. Inst. J.* 12 (Sept. 2003). Like Miller and Waisman, Warren and Westbrook do not accept our analysis whole heartedly. In particular, they believe that those exercising control rights do not tend to make value-maximizing decisions and that changes in legal rules might be able to curtail their power and restore Chapter 11 to something closer to its former role.

Miller and Waisman as well as Warren and Westbrook, raise a number of questions that LoPucki does not. In this paper, however, we focus on the interesting questions LoPucki raises.

² The numbers and percentages here (and elsewhere in this paper) are taken from LoPucki’s dataset, coded as he has coded them. We focus, as he does, on those that emerged from Chapter 11 in 2002. By focusing on cases that emerged in 2002, telecommunication companies are overrepresented. Neither their presence (nor any other peculiarity in the sample) changes the basic character of the results, however. While writing *End of Bankruptcy*, we vetted our observations against the cases in LoPucki’s database that filed in calendar year 2000, and the picture was much the same. Moreover, we based our observations of modern Chapter 11 practice on interviews with many reorganization lawyers whose experience again extended across a wide range of cases over the course of multiple years.

³ See note • *infra*.

Lynn LoPucki has written a thoughtful paper in which he agrees significant changes are occurring in large Chapter 11 cases.⁴ He also agrees that bankruptcy scholars must tie the animating principles of corporate reorganization law into a theory of the firm.⁵ Nevertheless, LoPucki has voiced doubts about our account of Chapter 11s and in particular whether it is consistent with recent large Chapter 11 cases, in particular those that concluded in 2002.⁶

In this paper, we address his concerns. We first compare Chapter 11 cases that concluded in the 1980s with those that concluded in 2002.⁷ We also review others LoPucki brought to our attention. These cases, most of which ended after we finished our article, reinforce the theme of *The End of Bankruptcy*: Traditional reorganizations are rapidly disappearing from modern Chapter 11 practice. In its place, a new practices (such as asset sales) have emerged that render obsolete standard accounts of the law of corporate reorganizations.

⁴ See *id.* at 26 (noting the sharp rise in bankruptcies of large, publicly held companies that result in liquidation). See also Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. Emp. Leg. Stud. (2004) (reporting that professional fees in large Chapter 11 cases have fallen 57% since the 1980s).

⁵ See Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, working paper.

⁶LoPucki stresses the sheer increase in the number of large Chapter 11s. See Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy*, 56 Stan. L. Rev. – (2003). See LoPucki at 1 (“Corporate reorganizations are booming”), 14 (“The boom in large firm reorganization proves Baird and Rasmussen’s conclusion wrong * * *.”), & 25 (“Big-case bankruptcy reorganizations have not ended. They are booming. Their survival cast doubt on the theories Baird and Rasmussen present * * *.”).

This emphasis is unfortunate. Our claim in the *End of Bankruptcy* was that the Chapter 11 process had changed, not that the number of large cases had fallen. To be sure, many of the developments that we discussed in *The End of Bankruptcy* leave little work for Chapter 11 to do when small businesses fail. But aggregate Chapter 11 filings have fallen in half over the last two decades and the number continues to decline. According to figures available from the American Bankruptcy Institute, there were 3022 Chapter 11 filings in the first quarter of 2002, and 2487 in the first quarter of 2003, a decrease of 17.7%. These figures include a small number of Chapter 11 filings by individuals. For the twelve-month period ending June 30, 2003, business filings were down by 5.2%.

An increase in the number of large Chapter 11s, however, is completely consistent with what we said in the *End of Bankruptcy*. That paper was about the new roles that Chapter 11 plays for large, publicly held corporations. In particular, Chapter 11 allows a sale with clean title. Moreover, it also allows senior creditors to overcome the holdout problems that accompany publicly held debt and to extinguish equity interests in insolvent corporations. To the extent that the increase in large Chapter 11 filings stems from an increase in these kinds of cases (and it does), the increase in filings supports our position, rather than undercuts it.

To challenge the empirical foundations of *The End of Bankruptcy*, LoPucki needs to show an increase in *traditional* Chapter 11s. These are the cases that we claimed have largely disappeared.

⁷ For these aggregate figures, we are again using LoPucki’s data as he has coded it.

I. Large Business Chapter 11s in 2002

In 2002, ninety-four publicly traded businesses with \$100 million or more in assets exited Chapter 11.⁸ Together these businesses had \$100 billion in sales and a half million employees. In these cases, Chapter 11 played two primary roles, neither much in evidence in the 1980s. In about half, the court oversaw the sale of the assets.⁹ In more than half the remaining cases,¹⁰ the bankruptcy judge reviewed and then confirmed a plan of

⁸ In the figures that follow, we do not include three of these businesses. The Chapter 11 against Huntsman Polymers was filed involuntarily. It was dismissed and Huntsman later reached a consensual restructuring with its creditors outside of bankruptcy. Two other businesses (ProMedCo and Xpedior) seem to have dissolved. LoPucki does not classify any of these as either emerging or liquidating. One might encode one or more of them as “not emerging,” but here as elsewhere we have opted not to recode any of LoPucki’s data. In any event, recoding would only further support the claims we made in *The End of Bankruptcy*.

⁹ LoPucki codes 47% of the Chapter 11s as “asset sales.” For purposes of assessing whether Chapter 11 was used to sell assets to a new owner (as opposed to restructure the obligations), this figure understates the number of sales. LoPucki codes a business as having emerging pursuant to a confirmed Chapter 11 plan even when the business is auctioned in Chapter 11 as long as the formal transfer of ownership is done in a plan and as long as the buyer maintains the business in a discrete legal entity. Hence, a business such as Fruit of the Loom is coded in the same way as a traditional reorganization, even though it was sold as a going concern in bankruptcy. (Warren Buffet acquired ownership of it through the plan rather than through a §363 sale and kept it a wholly owned subsidiary of Berkshire Hathaway.)

We are not faulting LoPucki’s coding. LoPucki’s database is the product of years of effort, and his decisions as to how to code cases were made well in advance of our analysis. These distinctions, however, do not focus squarely on the issues of concern to us. To assess whether we are correct in asserting that sales (including going-concern sales) are commonplace, one must distinguish between situations in which the bankruptcy judge conducts a sale and those in which she does not. The difference between “emerging” and “nonemerging” fails to do this.

To give another example, consider the way LoPucki codes cases in which the debtor agrees to sell the assets prepetition. LoPucki decided that “[h]aving a contract to sell the business is not a prenegotiation unless the creditors have agreed to the sale.” See Protocols at 20. One might argue that one cannot infer too much about the dynamics of the Chapter 11 from the failure of creditors to sign on to such deals. A debtor wants creditors who support the sale on the creditors’ committee, but some United States Trustees (in particular, the one in Delaware) will not appoint anyone to a creditors’ committee who has signed such an agreement.

For us, however, such prenegotiated agreements matter. To emphasize, we are not quarrelling with LoPucki’s coding decision here. It is his dataset, not ours. It was formed for different purposes and consistent protocols are essential to such an enterprise. Rather, in assessing our claims, one must be aware that his categories were not designed to identify the changes we discussed in *The End of Bankruptcy*.

¹⁰ By LoPucki’s reckoning, it is 26%. Again, this number understates things. We identify a number of cases that, while not coded as prenegotiated, are examples of preexisting deals being implemented in bankruptcy. By contrast, there is only one case coded as either prepackaged or prenegotiated that is not a case in which the bankruptcy judge implements a preexisting deal. In

reorganization already brokered before the start of the case.¹¹ Putting these figures together, the contrast between the 1980s and today is stark. During the 1980s, 88% of the

this case (Glenoit), the preexisting deal fell apart and the creditors opted for a plan that kept the business intact. Even here, however, we do not see a traditional reorganization that preserves jobs and helps communities. After leaving bankruptcy, Glenoit moved most of its production to China and used remaining sites in the United States primarily as warehouses and distribution centers. See Claudia H. Deutsch, *Burlington Made to Order for Investor Seeking a Test*, *New York Times*, August 14, 2003, Section C, Page 1.

¹¹ In challenging our claim that Chapter 11s often put in place a preexisting deal, LoPucki assumes that only what he classifies as “prepackaged plans” count as “preexisting deals,” not what he classifies as “prenegotiated plans.” See LoPucki at 3 & n. 13. In other work, LoPucki at times combines prepackaged and renegotiated cases, see Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 *Cornell L. Rev.* 967, 983 (1999), and at other times combines renegotiated and unrenegotiated cases, see Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 *Vand. L. Rev.* 1933, 1972 (2002).

For our purposes, the better approach is to combine the two. These “prenegotiated plans” do reflect “preexisting deals.” The prebankruptcy deal is not a deal with everyone, but it is a deal with those who matter, those who control the process. Of the 21 large Chapter 11s that exited Chapter 11 in 2002 that LoPucki classifies as having renegotiated plans, we see 16 of the renegotiated plans confirmed with only minor modifications: AMF Bowling, Anchor Glass, Audio Visual Services, Chiquita, Guilford Mills, Impsat Fiber Network, ITC DeltaCom, Inc., Lason, McLeodUSA, Mpower Holding, NTL, Stockwalk Group, USInterNetworking, Verado, Williams Communications, and Worldtex. We have an agreement that came before the Chapter 11, and the Chapter 11 in fact put this agreement into effect.

In four other cases in which there are renegotiated plans, the plan that was confirmed did depart from the renegotiated plan in substantive respects. In none of these cases, however, do the changes in Chapter 11 alter to basic contours of the deal struck before the petition was filed.

In Sunbeam, out-of-the-money subordinated debenture holders were able to extract 1.5% of the equity by claiming rights arising out of prepetition financial misdeeds.

In WKI Holding, some bondholders increased their stake of the new equity from 5.1% to 8.35% by threatening to probe transactions between its parent and an affiliate of the parent that was also a secured lender to the debtor.

In Komag, the general outline of the plan remained the same even while a number of details changed. The senior lenders received less cash (\$82.5 million instead of \$85 million) and more stock (51.4% instead of 50.1%), and one class of claims was split into two.

In Pinnacle Holdings, the renegotiated plan provided for the acquisition of control of the equity by a new investor and a new credit facility. The plans for the new credit facility fell through and the preexisting senior lenders did the postpetition financing instead. The change affected only the senior lenders (the ones involved in shaping the renegotiated plan), and the essence of the plan—the transfer of control of the business to specified third party—took place as contemplated and according to the terms agreed upon before the case was filed.

In the last case, XO Communications, the renegotiated deal fell apart. Forstmann Little agreed to acquire control, but was able to back out when the company’s financial condition

large businesses entering Chapter 11s begin without a blueprint in hand and emerge as operating companies. By 2002, the percentage had fallen to 24%.

Moreover, when one looks at these emerging Chapter 11s in any detail, it becomes apparent that many bear little resemblance to the traditional reorganization. Most obviously, more than a third of these businesses (nine of twenty-three) had Chapter 11 reorganizations that are, upon examination, implementing preexisting deals or orchestrating asset sales. We can review these quickly.

Arch Wireless's Chapter 11 implemented a plan negotiated with its secured creditors before the bankruptcy, under which the secured creditors received new notes and 90% of the equity of the reorganized business. Unsecured creditors received a few cents on the dollar and old shareholders received nothing.¹²

York Research, a developer of energy production facilities, entered into a restructuring agreement with 99% of its portfolio bondholders before filing, and this agreement was implemented in Chapter 11.¹³ As provided in the agreement, existing plants were sold (with proceeds going to the bondholders). Projects under development were to be placed into a new business owned by the creditors and the existing management. Shareholders were wiped out.

Oxford Automotive spent a year planning its Chapter 11, and it filed to implement a debt restructuring agreement with CSFB Global. Before the Chapter 11 began, at a time when it held 80% of Oxford's outstanding bonds, Global agreed to exchange its bonds and invest \$50 million for a majority equity interest in the reorganized company. The Chapter 11 put this deal in place. Moreover, Oxford could not be characterized as a traditional reorganization that saves an operating business for another reason. Only the parent holding company entered into Chapter 11. Hence, the Chapter 11 did not even affect Oxford's manufacturing operations.¹⁴

proved worse than expected. The Chapter 11, however, was not a traditional reorganization, but rather a corporate takeover. There was, in substance, a sale of the business, and Carl Icahn emerged as XO Communication's owner.

One does not need to go beyond LoPucki's dataset to see that prenegotiated and prepackaged plans set themselves apart from businesses that he scores as emerging intact. Of the 25 large businesses that entered with a prepackaged or prenegotiated plan, the median time was 140 days, and only three took more than 300 days. Of the twenty-three that entered without a plan and later emerged, only four took less than 300 days and the median was over 400.

¹² Leon Lazaroff, Arch Wireless plans bankruptcy with creditors' backing, *Daily Deal*, December 6, 2001; April 1, 2002 Bankruptcy Datasource Arch Wireless

¹³ York Announces Restructuring Agreement with Bondholders; Filing of Bankruptcy Petition, *Business Wire*, June 7, 2002. York Research Corporation, Plan Summary, Bankruptcy DataSource, August 1, 2002.

¹⁴ Oxford Automotive Arranges for Significant Capital Investment, PR Newswire, January 18, 2002; Michael Strong, Oxford Automotive: Ch. 11 plan will pay vendors in full, *Crain's Detroit Business*, January 28, 2002.

Derby Cycle entered Chapter 11 as the second part of a plan, conceived by its investment bankers many months before, to sell its assets. The bankruptcy judge approved the asset sale within five weeks of the petition. In the words of Derby's investment banker, "[B]ankruptcy can be a tool to get a transaction done . . . This was a situation where it made a lot of sense for a lot of reasons to file for bankruptcy. But the primary reason was speed—we were just able to [do] the transaction a lot more quickly."¹⁵

Five cases from 2002 were in effect assets sales. Fruit of the Loom filed for Chapter 11 at the end of 1999. From the beginning, the senior creditors exercised control. They planned initially to take an equity interest in the company, but when competing bidders appeared, they were content for the bankruptcy judge to conduct a sale. Warren Buffet's Berkshire Hathaway proved to be the high bidder at \$800 million.¹⁶ Similarly, George St. Laurent was the high bidder for Fine Air Services.¹⁷

In Sterling Chemicals, the court oversaw the sale of one half of the company and the proceeds went to the secured creditors. A new investor acquired most of the equity of the remaining business, with the balance going to the unsecured creditors. The equity was wiped out, and, as provided in the plan of reorganization, the entire board of directors tendered their resignations. The new investor controlled the appointment of their successors. Similarly, a distressed-debt fund acquired control of Classic Communications in Chapter 11 and became its owners as part of the reorganization plan.¹⁸

Global Crossing, one of the largest bankruptcies ever, was from the start a sale of the business to a new investor. The company filed with an agreement in principle in hand that would have sold 61%.¹⁹ After delays and a search for other bidders, the bankruptcy

¹⁵ Mairin Burns, Corporate Restructuring Takes a Transatlantic Turn; European Bicycle Maker Derby Cycle Reorganizes Stateside Via Chapter 11, High Yield Report, November 5, 2001.

¹⁶ In a similar vein, Seitel, whose primary business is selling seismic data to oil and gas companies, had assets that it valued at \$398 million when it filed for bankruptcy on July 21, 2003. Under the terms of its prepackaged bankruptcy, Berkshire Hathaway is financing the plan of reorganization and will receive 100% of the equity of the reorganized business. See Bankruptcy Week, Vol. 3, No. 30 1, 5 (July 28, 2003).

¹⁷ See Brendan Sobie, New Partnership Forged in Competition to Buy Fine Air, Air Transport Intelligence, January 30, 2002. It is worth noting that a minority investor who invested \$2.5 million in new corporation that proved to be the winning bidder was the old equityholder. He received a seat on the board and 24% of the equity in exchange. If one collapses the transactions together, Fine Air is, in effect, a new value plan that satisfies the requirements of Bank of America v. 203 North LaSalle Street Partnership 526 U.S. 434 (1999).

¹⁸ Mike Farrell, Classic Emerges with New Owners, Multichannel News, January 6, 2003. In the plan, the buyer acquired a majority of the seats on the board and its principal became chairman. Within six weeks of confirmation, the fund transferred the management of the company to an experienced cable operator. Jerri Stroud, Kent Makes Another Comeback, Diving Into Cable Business Again, St. Louis Post-Dispatch, February 13, 2003, C1.

¹⁹ See *Global Crossing Ltd. Files for Bankruptcy*, Wall Str. J. A3 (Jan. 29, 2002).

court confirmed a plan of reorganization that consisted primarily of a purchase agreement under which the prebankruptcy suitor would still get 61% of the equity.²⁰

Sales are often just off-stage even when they are not consummated in Chapter 11. Weblink Wireless planned to enter Chapter 11 in order to merge with another business.²¹ This deal fell apart, but Weblink entered Chapter 11 and continued to look for a buyer.²² Another deal with a different buyer fell through during the course of the case.²³ When Weblink emerged from bankruptcy, its secured creditor owned the equity and controlled the newly formed board of directors. Within four months, the secured creditor sold its controlling interest to a third party, which then took over the company.²⁴

Here it is important to underscore again what is at stake. In *The End of Bankruptcy*, we did not argue that the number of large Chapter 11 cases was falling or that Chapter 11 should be abolished. Our claim rather was that the dynamics of modern Chapter 11 had changed radically and that the prototypical Chapter 11 put forward in conventional accounts was a thing of the past. Going-concern sales and implementing prenegotiated deals dominate the scene. We argued that going-concern sales in Chapter 11 showed the extent to which the market provided a way to resolve the problems of businesses in financial distress. Using Chapter 11 to implement preexisting deals showed the extent to which creditors now exercised control outside of Chapter 11. They can now bargain readily with one another and a common debtor outside of bankruptcy. These cases buttress these observations.

Viatel and Teligent are large Chapter 11s emerging in 2002 that illustrate another claim of *The End of Bankruptcy*—that Chapter 11 no longer serves as a place where different constituencies sit down to find a way to preserve an established business. These two companies were so transformed during the course of the Chapter 11 that the emerging entities could hardly be considered the same business at all. Viatel entered Chapter 11 as an international long-distance telecommunications business headquartered in New York with 2,000 employees. It emerged 13 months later as a business, based in England, that employed only 77 and specialized in the sale of fiber optic capacity to long-distance car-

²⁰ A number of terms changed (including a dramatic decrease in the amount of cash that the new buyer put on the table) because the financial condition of Global Crossing changed over the course of the chase. Global Crossing's Plan of Reorganization was confirmed on December 26, 2002. The Plan included a purchase agreement that set forth the terms of the acquisition, pending regulatory approval. As of August 12, 2003, the parties still planned on consummating the purchase. In a related bankruptcy, Asia Global Crossing filed its own Chapter 11 case on November 18, 2002. Substantially all of its assets have been sold to Asia Netcom.

²¹ Metrocall & Weblink Agree to Merge, Business Wire, April 2, 2002.

²² Weblink Wireless Prepares to File Plan to Emerge from Chapter 11, PR Newswire, October 31, 2001.

²³ Weblink Wireless Files Plan of Reorganization; Company Signs Letter of Intent with Sun Capital Acquisition, January 31, 2002; Weblink Wireless, Bankruptcy DataSource, August 1, 2002.

²⁴ Leucadia National Corporation Announces Six Month 2003 Results, Business Wire, August 13, 2003.

riers and large corporations. It no longer has any assets in the United States.²⁵ Teligent entered Chapter 11 with 2,000 employees as a business trying to use wireless technology to compete with local telephone companies. It emerged with fewer than 100 employees as a company that is trying to use its wireless licenses to provide transport services to other carriers and point-to-point broadband access services for multi-location businesses.²⁶ What is going on in Chapter 11 in these cases may be entirely salutary, but it has nothing to do with preserving an existing business.

The remaining companies that emerged in 2002 (less than 15% of all the companies in this sample) illustrate one last important theme of *The End of Bankruptcy*. Financially distressed businesses today tend to have relatively little value as going concerns. Even if Chapter 11 serves to keep them intact, it is no longer preserving value in the way an equity receivership ensured that a railroad kept running. Consistent with this claim, the businesses that emerged from Chapter 11 in 2002 do not have much value beyond what their discrete assets are worth if sold separately.

FLAG Telecom entered Chapter 11 for a traditional reason. While it was in the midst of renegotiations with creditors, one of them declared a default and accelerated its loans.²⁷ FLAG filed to keep its creditors at bay. But FLAG was not a case in which either the managers or those on the board of directors were in the driver's seat. FLAG emerged from Chapter 11 only five months later with equity wiped out, a new board and the old creditors in control. More to the point, FLAG possessed little going-concern value. FLAG's principal assets were three separate undersea fiber optic cables.²⁸ Each could have been sold separately or transferred to the creditor that held the senior interest in them.

Six of the remaining businesses were little more than groups of discrete businesses, each of which could stand on its own. Three were a collection of nursing homes and residential care facilities.²⁹ One managed vacation resorts scattered across the country and another was a chain of movie theaters.³⁰ Still another operated a several dozen hotels under several different franchise names.

²⁵ Leon Lazaroff, Viatel Set to Exit Chapter 11, *Daily Deal*, May 10, 2002.

²⁶ Yuki Noguchi, Teligent Exits Chapter 11 Debt-free, *Newsbytes*, September 13, 2002; Teligent Completes Its Reorganization—Company Exits Bankruptcy Fully Funded and Debt Free, *Business Wire*, September 12, 2002. The general creditors, like the shareholders received nothing. Indeed, the case was administratively insolvent. See *In re Teligent, Inc*, 282 Bankr. 765 (Bankr. S.D.N.Y. 2002).

²⁷ See FLAG Telecom Holdings Ltd., *Bankruptcy DataSource*, Plan Summary, August 1, 2003.

²⁸ Tola Sargeant & Anthony Cox, No Silver Lining for Subsea-Cable Industry as FLAG files for Chapter 11, *Telecom Markets*, April 22, 2002.

²⁹ These were Sun HeathCare, Mariner Post-Acute Network, and CareMatrix.

³⁰ These were Sunterra and Carmike Cinema respectively. Carmike Cinema was able to pay its creditors in full in large part because it was able to use Chapter 11 to extricate itself from real estate leases. Taking advantage of substantive rules in Chapter 11 that depart from the nonbank-

This last business (Lodgian) nicely illustrates what is at stake in such cases. A business such as Lodgian has value as a going concern only to the extent there are synergies when one company runs a Holiday Inn in Mertle Beach, a Hilton in Fort Wayne, a Radisson in Phoenix, and many others scattered around the country. Independent of Lodgian, each hotel enjoys the services its own franchisor provides. Holiday Inn, Hilton, and Radisson each have their own national reservation systems as well as marketing and advertising programs. A creditor of Lodgian can foreclose on the equity Lodgian holds in the corporation that runs the Holiday Inn in Richfield, Ohio, and that Holiday Inn would still remain open for business, employing the same people.³¹ The individual hotels are separate corporations that stand on their own.

When we ask what is being preserved in Chapter 11 in a case such as Lodgian, we have to isolate the business of Lodgian proper. Lodgian can enter into single contracts with food, telephone and software providers. It can provide centralized accounting, tax, and payroll services. It can help train employees. If Lodgian can provide such services more cheaply than others, it may have value as a going concern. But we have to focus on these services, not on the underlying assets that stand on their own. Lodgian is a business employing the 118 people in Atlanta who oversee a portfolio of 97 hotels. Not at risk is the value of the hotels themselves. These are discrete businesses and which together employ 5,000 people and generate \$400 million of revenue a year.³²

Lodgian is emblematic of many of the businesses that emerged intact from Chapter 11 in 2002. They are not like 19th railroads or the large factory in a small town frequently put forward as the archetypal Chapter 11. These businesses do not resemble a steel mill where the physical assets have little value and jobs disappear if the business shuts

ruptcy baseline rather than a need to preserve going-concern value seems to have driven its Chapter 11 filing.

³¹ As part of its reorganization plan, Lodgian cast over several hotel properties, including its Holiday Inn in Richfield in Ohio. It remains a Holiday Inn.

³² LoPucki does not focus on this issue squarely in his discussion of Enron. The bulk of Enron's assets were put up for sale shortly after it filed for bankruptcy. These asset sales raised \$3.2 billion. This figure does not include any return for the sale of Enron's once-vaunted trading operations. See Disclosure Statement at 212-13. Two small pipeline companies, one based in the United States and one based abroad, and a utility company in Oregon are likely to be distributed to creditors as part of Enron's plan of reorganization. See, e.g, Enron Board Approves Proposal to Create New International Company, Press Release (5/9/03.) Hence, LoPucki counts Enron as a business that emerges from Chapter 11 with at least one operating entity intact.

But the small pipeline companies that will emerge were themselves never in Chapter 11. The only question was over the ownership of the equity of these corporations—would the stock be sold directly to an outside purchaser or would it be distributed to Enron's creditors, who could then sell their shares on the market. The question was over whether to sell Enron's asset—the shares—not the assets of the pipeline companies proper. As neither pipeline company ever entered Chapter 11, Chapter 11 cannot be said to preserve *their* value as going concerns.

down. More often the value that is being preserved is not the underlying hotel, theater, or nursing home, but the value of having them under common ownership.

The four companies that most fit the profile of a traditional reorganization are those that remain: ICG Communications, Kitty Hawk, Metals USA, and Pillowtex. Even these cases, however, do not suggest much of a future for the traditional reorganization. In ICG Communications, we see again senior creditors in control of the process. By the time it entered Chapter 11, a new CEO, recommended by one of the principal creditors, had been put in place.³³ Once in Chapter 11, the new CEO hired Wasserstein Perella to shop the business and decided not to sell it only because it did not “create the most value for creditors.”³⁴ The air cargo carrier Kitty Hawk spent two years in Chapter 11, but again the creditors ended up in control of the business, the CEO was gone, and the equity was wiped out. Metals USA was formed in the 1990s as an amalgamation of a number of different metal processors. Industry experts raised doubts about whether these businesses should have been brought together in the first place.³⁵

Of all the cases, Pillowtex is the one that provides the best counter to our claim that traditional Chapter 11s have disappeared. The manufacturer some of the well-known textiles – Fieldcrest, Cannon and Charisma sheets and Royal Velvet towels, Pillowtex filed for bankruptcy in 2000 in order to “create a sustainable capital structure, improved manufacturing operations, and profitability.”³⁶ After some pruning of its assets, it emerged in 2002. The business continued to run the same plants, employ the same workers and maintain the old relationships.

The rationale behind the traditional reorganization, however, was that it preserved going-concern value, and it is not obvious that Pillowtex had any. The going-concern value of Pillowtex cannot exceed the costs of outsourcing their manufacture, sale, and distribution. It cost millions to build Pillowtex’s factories, hire its thousands of employees, and create all the relationships needed for its manufacturing process, but these have no value as a going concern in a world in which the towels, pillows, and sheets can be made under the same label for less off shore. The “successful” traditional Chapter 11 from which Pillowtex emerged in 2002 only postponed the inevitable. Pillowtex filed for Chapter 11 again in July 2003, and in this one its assets are being sold off piecemeal.³⁷

³³ Kris Hudson, *Step One: Finding a new Leader ‘one shot at profitability.’* Denver Post, K-04, June 9, 2002. The decision to hire the turnaround formally rested with the board, but the board recognized that their fiduciary duties were owed to the creditors: “Realizing that their allegiance needed to shift from ICG’s shareholders to its creditors as ICG’s condition worsened, the directors made Curran their new chief executive officer.” *Id.*

³⁴ See Jeff Smith, *ICG Hires Firm to Seek Buyers for Telecom*, Denver Rocky Mountain News, Nov. 18, 2000. p. 15.

³⁵ See Corinna C. Petry, *Metals USA: The Unravelling of a Rollup*, Metal Center News, October 1, 2002.

³⁶ See Bankruptcy Database.com

³⁷ Details of the auction are available at www.pillowtex.com.

It is possible, of course, to downplay the extent of the changes we see in Chapter 11. Financially distressed businesses still file for Chapter 11. Negotiations still take place in Chapter 11 and part of the judge's job is to keep these negotiations on track.³⁸ Eliminating out-of-the-money creditors, and resolving intracreditor fights have long been part of Chapter 11. One can find a Pillowtex here and there. But none of this should obscure the magnitude of what has changed or the need to explore why this change has taken place. Understanding these changes was the principal focus of *The End of Bankruptcy*, and we return to it in the remaining parts of this paper to address other concerns LoPucki raises.

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II. Asset Sales and Absolute Priority

In *The End of Bankruptcy*, we suggested that the traditional Chapter 11 assumed a conjunction of circumstances that rarely exists today. Its disappearance reflects fundamental forces that have been work for a long time, not a short-term blip in the economic cycle.⁴⁰ Not only is going-concern value smaller in a business that consists of a number of discrete hotels, but it is also less likely to be present in those businesses of this type that need to use Chapter 11. A business that has developed an efficient way to manage dozens of different hotel franchises does not usually encounter financial distress—its competitors do. Even when the expertise does exist and the business is in distress, creditors are better able to prevent fights among themselves to put the assets in jeopardy. If all else fails, we can usually preserve going-concern value with a going-concern sale. Creditors no longer fear that the failure to reach a deal with current managers will lead to a piecemeal break-up of the business in which value is lost.

The dominant feature of the large corporate Chapter 11 today is the asset sale. It is common wisdom today that a large corporation is in play.⁴¹ Selling a business in Chap-

³⁸ Miller and Waisman focus on these in their response to *The End of Bankruptcy*.

³⁹ It would be tempting to end our reply here, as much of LoPucki's paper rests on the assumption that our paper could not be reconciled with modern Chapter 11 practice. Nevertheless, we do want to address the additional concerns he raises that are not based on empirics.

⁴⁰ Indeed, as *The End of Bankruptcy* makes plain, we believe these changes have been underway for a long time. The sources of the changes we see in Chapter 11 practice can be traced back to the 1980s and the more basic changes in the economy itself further still.

⁴¹ In his account of Chapter 11, LoPucki focuses on whether the sale was contemplated at the time of the filing. Intentions at the time of the filing, however, should not be the focal point. The principal players now understand that putting a business in Chapter 11 has the effect of putting it on the auction block. Going-concern sales have become a dominant part of Chapter 11 practice and this was simply not the case twenty years ago.

In any event, LoPucki finds that a sale was contemplated at the time of the filing in about 40% of the business he codes as "not emerging" and this figure underestimates the extent to which sales are contemplated at the time of the filing. For example, Budget's negotiations with Avis were public a month before it filed its petition, and Avis entered into a formal agreement to buy it only several weeks after the petition. The dip financing was conditioned on the sale to Avis

ter 11 is no longer a last resort, but an option to be exercised at any time it is in the creditors' interest. Indeed, the contracts of the managers (particularly the CROs and CEOs put in place at the time the business enters Chapter 11) give them incentives to sell the business.

Asset sales preserve a business's going-concern value in a way that undercuts the liquidation/reorganization dichotomy that marks much discussion about bankruptcy law. Bankruptcy scholars for years have viewed the choices facing a corporation as either to reorganize consensually in order to preserve going-concern value or have its assets sold piece by piece for a fraction of their value. Such a fear is largely misplaced. We see sales of discrete divisions and units, but only because they are thought to maximize value.⁴² Creditors may at times decide that the market for a group of assets is depressed,⁴³ but, across the broad range of cases, asset sales do not destroy going-concern value. Rather, asset sales are a way to preserve what going-concern value may exist by putting the corporation's assets into new hands.

Sales, as LoPucki points out, place a value on the business today, thus eliminating the option value of junior investors.⁴⁴ When there is an asset sale, the proceeds are often less than what the most senior creditors are owed. Those junior to them are often wiped out. If the sale had not taken place, the values might have increased. Junior interests have value as long as there is no day of reckoning.

This collapsing of all future possibilities into present value, however, is not unique to asset sales. Regardless of whether there is an actual sale or the hypothetical sale that takes place in a traditional reorganization, the absolute priority rule requires a valuation in every case. This valuation collapses future values to the present and fixes everyone's rights. Hence, even when we do not have asset sales in large Chapter 11 cases, equity-

going through. The majority of the unsecured creditors were especially anxious for the sale to go through, and they were willing to sign a lock-up agreement with Avis before the petition, but did not as it would disqualify them from service on the creditors' committee.

Exodus Communications entered Chapter 11 after its efforts to find a buyer outside had failed. Within weeks, it reached a deal with Cable & Wireless, a buyer whom it had courted unsuccessfully several months before it filed.

⁴² Comdisco reached an agreement to sell one of its principal businesses to Hewlett Packard for \$610 million before filing for bankruptcy. As has become commonplace, the bankruptcy judge insisted that others have the chance to bid. An auction ensued and this division was ultimately sold for \$835 million to another buyer within several months of the petition. Comdisco then proceeded to find buyers for the rest of its assets.

⁴³ See Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. Fin. 1343 (1992).

⁴⁴ LoPucki focuses on how sales extinguishes the rights of equityholders. As we note below, equity is nearly always wiped out in modern large Chapter 11s, even when there are not asset sales. Nevertheless, LoPucki's observation about the importance of taking option value of junior investors into account is surely correct and applies equally to junior creditors.

holders typically get wiped out.⁴⁵ This effect of the absolute priority rule generates strategic behavior that is hard to overcome.⁴⁶ Hence, alternatives to the absolute priority rule (such as relative priority) may make more sense. Bankruptcy scholars have paid too little attention to this feature of the absolute priority rule. Understood in this way, LoPucki's observation is well-taken, but it is not an objection to asset sales.⁴⁷

⁴⁵ LoPucki's dataset once again makes this point clear. Of the businesses that emerged with a plan formed in Chapter 11, equity is unequivocally wiped out in 17 of the 23 cases: Arch Wireless, CareMatrix, Classic Communications, Fruit of the Loom, Global Crossing, ICG Communications, FLAG Telecom, Kitty Hawk, Mariner Post-Acute Network, Pillowtex, Sun HealthCare, Teligent, Sterling Chemical, Sunterra, Weblink Wireless, Viatel, and York. Equity is also wiped out in Fine Air (with the caveat, noted above, that the old equityholder was a minority investor in the company that was the high bidder at the auction conducted by the bankruptcy judge).

Equity did hold onto some stock in Oxford Automotive and perhaps in Derby Cycle as well. Both, though coded as entering without prenegotiated plans, implement deals struck before bankruptcy. In Carmike Cinema, equityholders retained some stock, but in that case creditors were paid in full.

Metal USA is interesting in that it is one of the few corporations in which equity was not wiped out. Old stockholders were given warrants. The exercise price of the warrants, however, was so high, that the old shareholders would exercise them only if the stock proved valuable enough to pay the creditors in full. See Metals USA, Inc., Bankruptcy DataSource, Plan Summary, October 1, 2002. Although the warrants would give the equityholders only 15% of the equity in the end, the basic structure of the plan resembles not so much a traditional one as one that implements Bebchuk options. See Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

Lodgian was the only insolvent business that entered bankruptcy without a preexisting deal in which the equityholders received some equity. Here the equityholders mounted a challenge to the rights of one creditor class to reach across different corporate entities. The dispute resulted in a deal in which the equity received 3% of the new equity and warrants. (The plan itself nominally wiped out the equity. Equity received its share as a result of a side-deal with the creditor class.)

⁴⁶ Donald Bernstein sets out the various forms of strategic behavior at work here in Donald Bernstein, •. He argues that, in large cases, financial instruments can remove the costs associated with collapsing future values to the present in Chapter 11. His approach, however, can be used when assets are sold as well as when businesses are reorganized.

⁴⁷ The importance of taking the option value of junior investors into account has, of course, been known for a long time. Robert Swaine developed this idea during the 1920s. Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 Colum. L. Rev. 901, 912–23 (1927). In a previous paper, we examined Swaine's contribution to the law of corporate reorganizations. See Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 Sup. Ct. Rev. 393, 401–408.

It would also be a mistake to think that this feature of bankruptcy law is something that we have neglected. We provide a detailed account in Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001).

III. The Search for Chapter 11

LoPucki believes that businesses possess value as going concerns in ways that we do not appreciate and hence we underestimate the extent to which they may be lost in an asset sale. By his account, going-concern value arises from two sources – fungible assets and relationships – and a Chapter 11 process orchestrated by the corporation’s board of directors is the vehicle of choice for maintaining this value. We look first at going-concern value and then turn later to the question of whether boards can play the role that LoPucki ascribes to them.

A. Fungible Assets

LoPucki suggests that we have understated the value that adheres to the assets of a business even when they are fungible when seen in isolation. At LoPucki’s suggestion, we begin with a particular case (*In re 26 Trumbull Street*). The restaurant that occupied the space at 26 Trumbull Street, in Hartford, Connecticut, went through bankruptcy twice during the 1980s.⁴⁸ In both cases, the restaurant closed its doors before entering bankruptcy. The same trustee was appointed to dispose of the assets each time. The first time the trustee found a new owner willing to pay a premium to acquire the restaurant’s equipment and furnishings along with the lease of the space. The second time, the trustee found no such person and sold the assets piecemeal.

These two different outcomes is at first puzzling. The time between the two sales was quite short and the individual assets themselves had not changed appreciably. Nevertheless, the same trustee at the second sale could get only a fraction of the price he was able to obtain at the first, despite the fact that physical assets had changed hardly at all. The explanation for this difference provides a nice illustration of how going-concern value comes into being, how it can be lost, and why traditional reorganizations can do so little to preserve it.

The story begins in 1980, when *Hubbard’s Park* opened its doors. At first, it thrived. *Hubbard’s* was both the place where politicians hung out and the center of nightlife in city.⁴⁹ The restaurant changed hands and its fortunes plummeted. Within a year, the restaurant closed and filed for bankruptcy. Piecemeal sales are the order of the day for restaurants that close their doors. No one will pay for a restaurant that has already failed. Someone who acquires the space might use the kitchen as is, but the dining room and the menu have to change in order avoid the fate that landed the restaurant in bankruptcy. But *Hubbard’s* may have been different, as its problems could be tied to the new owners, rather any problem with the food or the ambiance. There was a winning formula. The menu could stay the same. The furniture, the bar, the espresso machine and the décor all worked together. Perhaps the only thing the space at 26 Trumbull Street

⁴⁸ LoPucki discusses only the first bankruptcy. The second one did not generate any published opinions.

⁴⁹ Interview with John Neil, July 24, 2003; Closed City Restaurant May Reopen, Hartford Courant, June 5, 1992 p. D4.

needed was competent management. At least, there was an investor willing to spend \$165,000 on this proposition.⁵⁰

The trustee in this case was not selling a collection of fungible assets,⁵¹ but rather a “turn-key operation.”⁵² What was being sold at auction was a restaurant with an established track record and client base, not used restaurant furnishings and equipment. The high bidder only needed to dust everything off and then open for business. There was no need to spend the hundreds of thousands of dollars it usually takes to create a new restaurant.⁵³ Chapter 7 sales of the sort that took place in *26 Trumbull Street* are typically classified as “liquidations,” but the trustee will sell assets as a going concern when doing so will bring a higher price.

The first bankruptcy of the restaurant at 26 Trumbull Street illustrates a business in financial distress with potential going-concern value. The apparent cause of its financial distress—a period of bad management—suggested that there was a viable business that could generate much more than the value of its hard assets in a piecemeal sale. The going-concern value of a restaurant turns on whether the business plan is sound. The original cost of the carpeting or the wall covering is irrelevant. The cost of bringing these together bears no necessary relation to how much going-concern value exists. What matters is whether they create a mood that leads people to want to eat there.

The trustee conducted a piecemeal sale in the second bankruptcy because by this time potential investors realized that this restaurant’s moment had passed. There was no shortage of people who wanted to run a restaurant at 26 Trumbull Street, but no one wanted to run *this* restaurant. The equipment and furnishings had no value kept together. Anyone who operated a restaurant at the spot had to try something different. Creating a new look is costly (ordinarily running in the hundreds of thousands of dollars). Once again, however, the value of the new look, the value associated with the new furnishings, turns once again not on their cost, but on whether the assets together with the business systems the new owner puts in place attract customers and generates positive earnings.

In the case of 26 Trumbull Street, a succession of new owners failed to find a winning formula. *Jonathan’s* became *Metro Park Café*, which in turn became the *Blue Star Café*. In none of them was there any going-concern value. A business that cannot generate enough money to pay its ongoing expenses is worthless, no matter how much it cost to

⁵⁰ While \$165,000 was more than the fungible equipment was worth if sold piecemeal, the cost to the investor was far less than buying the equipment and attempting to revamp the restaurant. The cost for refurbishing a restaurant and installing a new formula usually ranges between \$500,000 and \$1 million. Interview with Robert Maffuci, September 9, 2002.

⁵¹ See LoPucki at 7.

⁵² The trustee in both cases, John Neil, used exactly this expression to distinguish the first bankruptcy case from the second. Interview with John Neil, *supra*.

⁵³ This is the cost assumes that the infrastructure, including the kitchen, is sound. If not, the cost is higher, likely much higher.

build. Increasingly, those who try to open a stand-alone restaurant and run it with the management system they develop on their own fail. Successful restaurants are more often the creation of those who have opened other restaurants and have a management system that they can replicate.

The space at 26 Trumbull Street became successful only when Rob Maffuci and his family acquired it in 1996. Already the owners of a number of successful restaurants, they brought their knowledge to the space and opened *Vito's by the Park*. Maffuci redid the dining space to take maximum advantage of the view, including a large mural that mirrored the view of Bushnell Park through the restaurant's windows. Maffuci added a piano bar and created a carry-out business during lunch. Complimentary pizza has made it one of the favorite Happy Hour spots in Hartford. Today it is a thriving business that employs 35. Already seven years old, *Vito's* is now well into middle age.⁵⁴

In re 26 Trumbull Street shows how the observations we made in *The End of Bankruptcy* apply with full force to small businesses as well as large ones. Moreover, recent empirical work points to the same conclusion. Edward Morrison looked at all operating corporations that filed Chapter 11 petitions in the Eastern Division of the Northern District of Illinois in 1998.⁵⁵ Morrison uses interviews and other techniques to take the pulse of each business and concludes that these businesses too had little in the way of going-concern value. The typical business is a construction subcontractor who has no equipment beyond a truck and hand tools. With no permanent employees, he hires people for specific jobs after winning a contract. The owner-manager has many relationships with other builders and suppliers, but these relationships reside with the owner-manager. They do not depend upon the continued existence of the corporation she is now running. They continue whether she runs the corporation that files for bankruptcy or a new one created shortly thereafter. As we survey the landscape of small businesses, we do not see the

⁵⁴ Much of the value of *Vito's* as a going concern depends upon Rob Maffuci remaining in place. Maffuci is a creative Italian chef who offers traditional Osso Bucco along with his own creations such as apricot shrimp. He has a prominent place in Hartford's civic life. As important, the experience Maffuci and his family gained running their other restaurants also allowed them to open *Vito's* with the smallest possible capital investment and then keep overhead low. The motivated and loyal staff is smaller than at restaurants of comparable size.

Notwithstanding his passion and enthusiasm, Maffuci is not a dreamer. Trained as an electrical engineer, he has put systems in place that kept food costs down and waste to a minimum. In addition, he continuously develops sidelines to the business (such as take-out and lunchtime deliveries) that add to the bottom-line.

A restaurant with a celebrity chef can have going-concern value that a traditional organization can preserve. But we recognized precisely this case—the celebrity chef and his restaurant—as an example of the rare business that has going-concern value in *The End of Bankruptcy*. More to the point, Maffuci is in no need of Chapter 11. His business is thriving.

⁵⁵ See Edward R. Morrison, *Bankruptcy Decision-Making: An Empirical Study of Small Business Bankruptcies* (dissertation, University of Chicago, August 2003).

elements needed for the traditional reorganization. As Morrison puts it, “There are no railroads here.”

B. Relationships

We do see large businesses, such as Revere and Greyhound, that go through Chapter 11 and continue as operating entities for many years after. That such businesses continue as going concerns for an extended period after emerging from Chapter 11 suggests that they have *some* value as going concerns.⁵⁶ If they had none, there is no reason for them to stay together. Moreover, we can identify potential sources of going-concern value. Large businesses have thousands of employees. Each employee has multiple relationships with each other and with the business’s many suppliers and customers. This vast web of relationships constitutes the firm. Large investments were required to bring it into being and investments on a similar scale would be needed to replicate it.

The idea of value flowing from relationships fits with the conception of the firm that Ronald Coase established long ago. A “firm,” as Coase understood it, consists of the “system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur.”⁵⁷ Instead of the price mechanism directing the flow of resources, an entrepreneur takes command of them. The relationships, not the assets, are the firm.⁵⁸

All firms have relationships; not all firms, however, have going-concern value. Chapter 11 is traditionally defended on the ground that it is needed to preserve businesses with going-concern value, not all firms. To make the case that a business has substantial value as a going concern, one must establish both that the business’s relationships are costly to replicate and that the business is itself sound. Neither is necessarily true.

First, relationships may be relatively inexpensive to put in place. Nothing about Coase’s theory of the firm requires that the relationships that constitute the firm must be

⁵⁶ Even here, however, we have to be careful. At the time it filed, Revere was best known for its copper-bottomed cooking ware. Revere sold this division to a business that ultimately became WKI, one of the large businesses emerging from Chapter 11 in 2002. By this time, RevereWare’s manufacturing operations had been outsourced to a factory in Indonesia.

No matter how much it cost to build and no matter how much it cost to establish the relationships, the value of a firm that makes RevereWare can never be more than the cost of producing the same goods offshore. This division (albeit only a part of Revere) once again illustrates the dynamic at work in cases such as Pillowtex and Glenoit.

⁵⁷ See Ronald H. Coase, *The Nature of the Firm: Origin*, in *THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT* 22 (Oliver E. Williamson & Sidney G. Winter eds., 1993)

⁵⁸ LoPucki states that we argue “[f]irms can have going concern value * * * only to the extent they have ‘firm specific’ or ‘dedicated’ assets.” LoPucki at 5. See also *id.* at 14 (“Asset-specificity is at the heart of Baird and Rasmussen’s concept of the firm.”). But our view is in fact to the contrary. Specialized hard assets are not what generates going-concern value in most businesses. This is the gist of our discussion of Ermen & Engels and the Ford Motor Company. See 760-62 and 769-72.

costly to create or replicate. Indeed, Coase's theory tells us that unless these costs are low, production will take place outside the firm.⁵⁹ Moreover, as transaction costs go down, the upper bound on the value of relationships of the firm go down as well. The cost of hiring a janitor is capped by the cost of hiring a janitorial service.

Those who move to new jobs do incur transition costs. You need to find where the water coolers are. But these can be exaggerated. Law professors can move back and forth to different schools in several jurisdictions in the course of a few months. CEOs are regularly hired from outside the industry.⁶⁰ Forming a business is, of course, harder. There is a critical mass of relationships that takes time to develop. If you open a new restaurant, even at a location that used to be a restaurant, it takes a number of months to train the workers, obtain suppliers, gain customers, adjust the menus, and so forth. But these costs too are easy to overstate.⁶¹ A restaurant has relationships with a variety of vendors, but switching to new vendors is easy and cheap.⁶² The Internet has made it even easier and cheaper. Moreover, the same forces that make these relationships easier to establish make it easier to sell a business as a going concern.

Even where relationships would be expensive to build anew, one needs a sound business plan to create going-concern value.⁶³ An absence of going-concern value is a common characteristic of many of the businesses that were liquidated in Chapter 11 in 2002. WebVan's infrastructure cost hundreds of millions to put in place, but it could not deliver groceries in a way that competed successfully with ordinary supermarkets. Iridium spent billions putting satellites in orbit and creating a vast network of receiving stations on the ground. Relationships were established with telephone companies throughout the world, but Iridium proved to be worthless. Its value as a going concern turned on whether it could compete with other technologies and it could not.

In the end, one cannot rest Chapter 11 on the need to preserve relationships. Not all relationships have value. Even in financially distressed firms that have potentially costly and valuable relationships – firms that are hard to find – a traditional Chapter 11 proceeding is not necessary to preserve such relationships.

⁵⁹ As noted, one of the businesses LoPucki cites as having going-concern value—Revere—provides a nice illustration of the point. The same cooking ware can be made by a third party through contract as by the business itself.

⁶⁰ WorldCom and United's CEOs, hired just after or just before the Chapter 11, are examples.

⁶¹ In 1913, when Ford Motor Company was one of the most profitable companies in the world, it had an employee turnover rate of 380%.

⁶² Morrison reports that, *even among the restaurants that fail in Chapter 11*, old owners are able to establish another restaurant quickly at least 35% of the time.

⁶³ LoPucki slights the difficulty of crafting a successful business plan when he offers that “[s]imply by itself adopting a better operating plan, the reorganizing firm can save its low-level, firm-specific knowledge and expertise.” LoPucki at 9. Mainline carriers in the airline industry still have yet to “simply adopt” a operating plan that generates going-concern value.

IV. Control Rights in Chapter 11

LoPucki envisions a Chapter 11 process where managers mediate the interests of various constituencies. The board of directors is calling the shots. The residual owners of the business cannot be identified with certainty, and the board is well-positioned to take the interests of all into account. LoPucki, however, overstates the difficulty in ensuring that decisions are placed in the right hands and understates the constraints under which the boards of financially distressed corporations operate. We address each in turn.

A. Residual Owners

The law of corporate reorganizations offers a solution to the collective action problem that exists when too many creditors chase too few assets. But financial distress can be anticipated, and debtors can arrange their affairs in such a way that minimizes this collective action problem. No collective action problem exists when a business has a sole owner and no creditors. No legal regime is needed to preserve relationships in this environment, no matter how valuable they are. Most businesses have multiple parties with a stake in the assets. For businesses that have few debts relative to their assets, we can again look to the shareholders to make sensible decisions. They enjoy the benefits and bear the costs of almost any decision they make. Similarly, a business may be so hopelessly insolvent that a single senior creditor is effectively the residual owner.

As LoPucki properly points out, however, we must confront those situations in which there is no readily identifiable residual owner. By the time WebVan shut down, the unsecured creditors received less than 50 cents on the dollar. Hence, for some period of time, they were the residual owners of the business, but at no point were they involved in decisionmaking. The person making the decision about whether to keep the business running was not the residual owner. Observing that no residual owner exists, however, does not itself tell us that the decisionmaking that took place was bad or inconsistent with the interests of the general creditors.

It is easy to criticize WebVan for its initial missteps and the wasteful spending of its CEO, but none of this has anything to do with the choice facing WebVan in its last months—how long to keep the business running. As its founders observed early on, WebVan was the kind of business that would be worth \$10 billion or nothing.⁶⁴ The risks and the potential returns were high. In such an environment, one of the most important issues in designing the allocation of control rights is ensuring the shutdown decision is made at the right time. You do not want to give up on a huge capital investment, but at some point, you have to cut your losses.

At the time they invested, WebVan's general creditors, like everyone else, wanted to ensure that this decision was made at the optimal time. But they would not necessarily bargain for the right to make this decision themselves the moment they became residual owners. Among other things, they likely lack the expertise to make this decision at the optimal time. But the locus of the decision does not need to reside with them. Nor does

⁶⁴ See Randall E. Stross, *eBoys* 43 (Crown 2000).

the mechanism even have to entrust this decision to a single person. A variety of mechanisms can be put in place outside of bankruptcy to induce value-maximizing decisions.⁶⁵

In the case of WebVan, the decision to close WebVan was formally entrusted to equityholders or those beholden to equityholders. They have an incentive to keep the business running too long. But this picture is too simple. Start-up businesses like WebVan require cash. The managers running WebVan ultimately closed it down because they could not find additional providers of cash to keep it running. The managers would have a bias in favor of keeping the business running. The senior creditors would have a bias towards shutting it down. Providers of new cash, however, at first approximation, have exactly the right incentive. They will be willing to provide an additional dollar as long as the risk-adjusted return on that dollar yields them a competitive return. WebVan might lack anyone who is a residual owner, but it can nevertheless create a mechanism that yields sensible decisions by forcing those in control to return to capital markets to keep it running.

WebVan's unsecured creditors did not receive repayment in full, but this itself tells us *nothing* about whether control rights were allocated in a way that ensured it was shut-down at the right time. The optimal time to shut WebVan down turns on its liquidation value relative to the discounted present value of its future earnings, not on the relationship of liquidation value to the amount the unsecured creditors were owed.⁶⁶ To the extent that unsecured creditors would tend to shut the business down at the wrong time, one should not expect them to have the power to do so.⁶⁷

⁶⁵ We develop the idea that control rights can be allocated coherently even when multiple parties possess powers to affect decisionmaking in Baird & Rasmussen, *supra* note •. We do not rest on the idea that a single residual owner exists in every case. Hence, the argument that such creatures do not exist is neither here nor there.

In this respect, LoPucki seems to focus too heavily on the work one of us did in the early 1980s. See, e.g., Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 108-09 (1984). That work, while discussing the need to create mechanisms that allow disparate owners act as one, emphasized the advantages of ensuring that decisionmakers were residual owners who bore the costs and benefits of any decision they made.

⁶⁶ Shutting a business down at the right time is an optimal-stopping problem. In comparing the liquidation value and the going-concern value, one needs to take into account the option value associated with waiting. As a result, a business should be kept running even when the discounted value of its future earnings is *less* than its liquidation value. Baird & Morrison. For a formal proof, see Morrison, *supra* note •.

⁶⁷ One needs to be careful here. The right to call a loan, which many creditors have merely when they have "reasonable grounds for insecurity" is not the same as saying that it will be exercised whenever there is a default. Defaults ordinarily merely set the stage for negotiations. Even when they do not, they can force a shutdown only if the entrepreneur is unable to return to the capital markets.

The law allows parties great freedom to craft investment contracts in a way that is to their liking. People learn with time. The investment contracts in the typical large case are the product of careful design. Investors in large businesses allow capital structures to emerge in which those who have the power to make decisions are likely to make good ones. Moreover, the tensions that might exist in cases such as WebVan if its control rights were allocated incoherently, however, should not be exaggerated. Large businesses do not ordinarily find themselves in situations in which the senior creditors want to shut it down, while the junior ones do not.⁶⁸

More often, the decision is one that, if correctly made, will benefit senior and junior people alike. The business needs to find a chief restructuring officer. The question is who the best person is. Creditors with diverse interests can often agree on such questions or defer to someone who has more experience. To say that control rights tend to be coherently allocated is to say that those who have a voice in making this decision have both the skill and the incentive to make it correctly.⁶⁹ Enron is one of the most expensive and contested bankruptcies ever, but there was almost no disagreement with respect to the single most important decision at the start of the case—a decision to sell its trading operation to UBS. The sale went through without objection even though UBS was not willing to offer any cash for a business that, at the time, appeared to many to be worth billions.⁷⁰

We should not assume that residual owners are hard to find in large Chapter 11 cases. It is no accident that we commonly observe, as a large business encounters financial distress, multiple institutional creditors morph into a single revolving credit facility. When we look at recent large, prenegotiated Chapter 11 cases, one commonly observes that the senior bondholders are in fact the residual owners for all practical purposes. They use Chapter 11 not because there is a collective action problem, but because it is the easiest way for them to extinguish junior stakeholders that are out of the money. These are nearly half of all the nonliquidating Chapter 11s involving large businesses. The railroads had dozens of different bonds covering many different types of collateral. Capital structures today are better designed. The direction of the change is unmistakable and it takes us away from the traditional reorganization.

B. The Board of Directors

Directors, especially independent directors, play an important role in Chapter 11 that has received too little attention. Directors are keenly aware that their fiduciary duties

⁶⁸ As we have noted, small Chapter 11s are dramatically different in this respect.

⁶⁹ We elaborate on these points in other work. See Douglas G. Baird & Robert K. Rasmussen, *Corporate Governance, State-Contingent Control Rights and Financial Distress*, draft; Douglas G. Baird, *The New Face of Chapter 11*, draft; Robert K. Rasmussen, *Secured Credit, Control Rights and Real Options*, draft.

⁷⁰ Enron's massive trading operations reported earnings of \$3 billion. At the time of the filing, some might suspect these were exaggerated, but few thought the business was worthless.

run to the creditors and take it seriously.⁷¹ Often they become actively involved in the business only after it encounters financial distress. At this point, their concerns about their own liability (and the potential shortfall in the company's D & O insurance) ensure that they take the interests of the creditors to heart. Moreover, in many of the cases in which there is tension between the board and the creditors, we see a turnover of the board, either at the time of the Chapter 11 or at its conclusion. The change in control at the end of the case usually brings with it a new set of directors.⁷² In these cases, we cannot justify existing Chapter 11 as a mechanism uses the board of directors to preserve relationships beyond the time the plan is confirmed.

One must distinguish between the nominal power of the directors and the extent to which they defer to the creditors.⁷³ In *Adelphia*, the board hired a new CEO with an enormous benefits package, but the person was the first-choice of the creditors' committee and strongly opposed by the shareholders. In *United*, the Board oversaw the renego-

⁷¹ *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992).

⁷² The largest Chapter 11s to date include a number—WorldCom, Global Crossing, and *Adelphia* among them—had complete turnover of directors at the time of the Chapter 11 filing.

LoPucki's dataset provides many examples of board turnover as well. Among the Chapter 11s that emerged in 2002 without prenegotiated plans, we often see a complete turnover of the board of directors by the time the plan is confirmed.. *Metals USA* is a representative example. In that case, the plan provided for a new board of directors, appointed by the creditors committee. Their first task was to look for a new CEO. Nelson Antosh, *Metals USA Shrinks, Exits Bankruptcy*, *Houston Chronicle, Business*, p. 1, November 2, 2002. The appointment of a new board of directors by the creditors who emerge with control is a standard part of modern Chapter 11 practice.

To give some additional examples, a new board is appointed by the creditors upon confirmation in *FLAG Telecom*, *Kitty Hawk*, *Lodgian*, *Sun HealthCare*, *Sunterra*, and *Weblink Wireless*. In *Sterling Chemical*, the plan provided that the new buyer would designate five new directors and the creditors two. The new buyer of *Fine Air's* assets was a newly formed corporation with a new board of directors.

New directors were appointed during the case in *Global Crossing*. The new buyer appointed the majority of the new board in *Classic Communications*, apart from the CEO who remained (until the sale several months later). The balance of the new directors were appointed by the creditors' committee. We see a complete turnover in the directors at the time of *Pillowtex's* reorganization.

This account is not exhaustive. However desirable it might be to have a Chapter 11 that uses a board to preserve relationships, it is not descriptively accurate of current practice in large cases, at least not by the time the case is over.

⁷³ LoPucki misunderstands our observation of the role played by DIP financing. LoPucki confuses who retains the formal legal authority to implement a decision – the board of directors – with notions of control. DIP lenders, as we show elsewhere and LoPucki seems to acknowledge, places severe constraints on the board's options. See n.106. It is no answer to say that the DIP lender is not making these decisions because they were made by the Board when it sought DIP financing. Our point was that the DIP lenders effectively control the decisions because the Board has lost the ability to take actions that run contrary to the desire of the lenders.

tiations with the unions, but the sword of Damocles was held by J.P. Morgan through the financial covenants in its DIP financing agreement. Early in the case WorldCom's board had to hire a chief restructuring officer. The DIP financing agreement insisted that the board hire such an officer, but left the choice entirely up to the board—as long as it was a person on the list of three offered by the DIP lender.

Conclusion

When we examine the large businesses that enter Chapter 11 today, we find that we can no longer rest on the comfortable homilies of the past. Modern bankruptcy judges play an important and valuable role when they oversee auctions of going concerns and implement prenegotiated plans of reorganization. But Chapter 11 no longer serves anything like the role commonly ascribed to it. Even in those cases that look most like a traditional large corporate reorganization, the stakes are quite small. A collection of Marriotts and Holiday Inns is nothing like a railroad. A court-conducted sale of Fruit of the Loom in which the high bidder is Warren Buffet bears no resemblance to an equity receivership.

In examining the nature of the change that in the large corporate Chapter 11s of 2002, as opposed to those of the 1980s, we see that fundamental forces at work of the economy have made the traditional reorganization increasingly obsolete. Railroads had enormous going concern value and incoherent capital structures, while facing primitive capital markets. Today's business can be replicated with virtual businesses that organize production through the marketplace over the Internet.

Of all the cases to leave Chapter 11 in 2002, the one that most resembles a traditional reorganization is Pillowtex. Its many plants were in small communities that depended mightily on them. Pillowtex's board conscientiously mediated the relationships among employees, suppliers, and others during the two years it spent in Chapter 11. The Chapter 11 brought together diverse interests and fashioned a plan that gave the business its best chance going forward. But forces are at work that the best intentioned cannot stop. In the end, there is nothing bankruptcy can do to save Pillowtex. The value it once had as a going concern was gone. For better or for worse, the role that Chapter 11 can play in today's economy has little or nothing to do with reorganizing railroads or saving factories in small towns. Traditional reorganizations are all but gone. The end of bankruptcy is indeed upon us.

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