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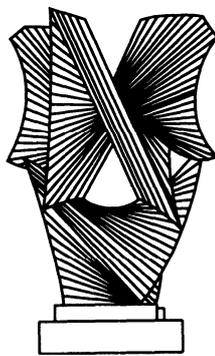
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REVISITING AUCTIONS IN CHAPTER 11

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REVISITING AUCTIONS IN CHAPTER 11

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When Eastern Airlines filed its bankruptcy petition in March 1989, its future was bleak. For decades, it had systematically invested in the wrong airplanes, beginning with a commitment to propeller aircraft in the late 1950s. Its cost structure was higher than its competitors'. It had failed to find a viable market niche in a deregulated environment in which the hub-and-spoke system brought significant economies of scale. Eastern had already sold its most valuable assets, such as its shuttle between Washington and New York, and its entire work force was on strike. Moreover, its service was poorly regarded and it had little good will with the general public. If Chapter 11 mandated that the assets of a publicly traded firm be swiftly sold, however, someone would have bought Eastern's airplanes and landing gates for an amount sufficient to provide a dividend to the preferred stockholders. Instead, the managers of Eastern and later a court-appointed trustee used the umbrella of bankruptcy law to try to keep the airline intact as a going concern. Over the next two years, Eastern lost over a billion dollars. The airline began liquidation only when its assets were insufficient to pay the administrative expenses, such as lawyers' fees, involved in running the bankruptcy case.¹

Financial News Network entered Chapter 11 in early 1991. Shortly afterwards, a joint venture between Dow Jones and Group W offered to pay \$90 million for FNN's assets. A unit of NBC countered with a bid of \$115. The bankruptcy court ordered an auction of the firm's assets. NBC eventually won with a bid of \$146 million and the creditors were paid in full. NBC acquired the assets in May 1991. The Chapter 11 proceeding continued because of the many disputes involving possible fraud committed by its directors. After the sale, however, resolving these disputes could have no effect

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¹ See Claudia MacLachlan, *Blame Flies in Demise of Airline*, *National Law Journal*, page 1, 35-36 (May 27, 1991) (vol. 13; no. 38).

on how the assets were being used, and the general creditors of FNN will likely be paid in Full.²

The contrast between *Eastern* and FNN makes it easy to argue that large, publicly traded firms should be put on the auction block when they enter Chapter 11 and sold to the highest bidder. A speedy sale separates the question of how to use the assets from the question of how rights to them will be allocated among creditors, shareholders, and others. Fights over rights to the assets no longer threaten to keep them from being put to their highest-valued use. The assets are no longer in the control of a bankruptcy judge or one of the parties to a priority dispute, but rather in the control of a person whose own money is on the line. That person is better positioned to know how to best use the assets and whether to keep the firm intact or sell of its assets piecemeal.

Neither *Eastern* nor FNN, however, are representative of large Chapter 11 cases. Eastern Airlines was eventually liquidated, while most publicly traded firms successfully reorganize in Chapter 11.³ In addition, Eastern Airlines' Chapter 11 petition was filed in the Southern District of New York, and reorganizations there are not representative of comparably sized firms elsewhere.⁴ It would be a mistake to press for dramatic reform of an entire system because of the behavior of a few judges. FNN was equally unusual. The auctions in FNN may have been possible only because there was more than one person that actively sought to buy its assets. Scholars not known for their hostility to market mechanisms (including Frank

² See Anne Rackham, *Media Keeps Going Through Drumbeat of Turmoil*, *Los Angeles Business Law Journal*, page 12 (December 30, 1991) (vol. 13; no. 52.)

³ Lawrence A. Weis, *Bankruptcy Resolution: Direct costs and violation of priority of claims*, 27 *J. Fin. Econ.* 285-314 (1990) (30 out of 37 reorganized).

⁴ See Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganizations of Large, Publicly Held Companies*, 1991 *Wis. L. Rev.* 11, 29-33. The Southern District of New York is thought more "debtor-oriented." It is more generous in its fee awards and more likely to extend the debtor's exclusivity period. Large cases to date in the Southern District has disproportionately come before a single judge, the same judge who heard Eastern.

Easterbrook) have suggested that the costs of mandating public auctions of large firms in Chapter 11 exceed the **benefits**.⁵

In an earlier paper, I argued that auctions of publicly traded firms should take place as a matter of routine shortly after the filing of a bankruptcy petition.⁶ In this paper, I revisit the question in light of the scholarship that has been done and the empirical data that has been gathered over the last 6 years. Everyone agrees that auctions in Chapter 11 are sometimes desirable and that sometimes, as in *FNN*, those in control will find an auction in their self-interest. Indeed, if those making the decisions in Chapter 11 were loyal agents of the owners of the assets as a group and if they could effectively communicate information about the firm to third parties, there would be no reason to *require* an early auction. Under these conditions, those in control could be counted upon to conduct such a sale if it were in everyone's interest. I suggest, however, that those in control often lack the incentive to act in a way that is in everyone's interest and that, even if they did, they might not be able to persuade third parties that they wanted an early sale to save the costs of bankruptcy, rather than to get rid of assets that they (but not others) thought would turn out to be worth less than those of firms that were indistinguishable to third parties. None of this would matter if remaining in Chapter 11 for several years brought with it few costs, but these costs, although still largely unknown, may be substantial. After a brief discussion of the existing legal regimes and possible reforms that fall short of mandatory auctions, I examine the costs even such a modified Chapter 11 imposes. I then look at the agency problems and other the barriers that prevent those in control from making decisions that consistent with the bargain to which everyone would agree *ex ante*. In the last part, I confront the costs that mandatory early auctions might bring.

I.

In this part, I set out briefly the relatively narrow question that I am confronting. First, I am not addressing the question of how

⁵ See Frank H. Easterbrook, *Is corporate bankruptcy efficient?*, 27 *J. Fin. Econ.* 411-17 (1990).

⁶ Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 *J. Legal Stud.* 127 (1986).

rights to assets should be divided in bankruptcy. I have advocated that rights be allocated in a way that was consistent with the original debt contracts, but nothing here turns on **that**.⁷ Rather, the question is whether disputes about rights to assets (however resolved) be separated cleanly from the question of how the assets of the firm are used. The question is whether a bankruptcy proceeding should focus entirely on resolving disputes among diverse parties with rights to the assets or whether it should also concern itself at the same time with running an ongoing business.

Second, I am focusing on only a small subset of the firms that file Chapter 11 petitions. Firms in Chapter 11 run the gamut from the very small to the very large. These firms face radically different problems when they are in financial trouble. One can, however, divide them into three rough groups. The first comprises two-thirds or more of the Chapter 11 docket. These are the small **mom-and-pop** businesses with assets of less than \$500,000. Fewer than 10% will ever successfully reorganize. For these **firms**, Chapter 11 is simply a way station to eventual liquidation. Although these cases dominate the docket in terms of numbers, they do not loom large as far as the stakes involved concerned. The total liabilities (and total assets) of these firms are less than 5% of those of all the firms in Chapter 11.⁸ The second group of cases involves closely held firms of substantial size that may in fact be worth keeping intact as going concerns. In these cases, it is hard to rearrange the capital structure of the firms without taking account of the firm-specific skills of the **manager-shareholders** and perhaps others as well. The firm may have a future

⁷ This is a view I share with many other scholars. Rasmussen has taken this argument to its logical extreme and argues that Chapter 11 itself should be simply one item on a menu of choices available to firms at the time they incorporate. See Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy* (manuscript March 1992).

⁸ Ed Flynn, *Statistical Analysis of Chapter 11*, Ernst & Young Study for Administrative Office of the U.S. Courts 12-13, 18-19 (October 1989). This is not to say, however, that these cases are not important. What is important are the social costs of these bankruptcy cases. Not only may these cases bring few benefits, but the deadweight costs of these bankruptcy cases may be quite large. The direct costs of bankruptcy consume a larger portion of the assets and the indirect costs—principally delaying the liquidation of a firm that cannot compete—may be much larger, in relative terms, than in the case of larger firms that will, in all likelihood, remain largely intact.

The large, publicly traded firm is the case in which making the case for the mandatory auction is easiest. It is not enough, however, to assert that a regime of mandatory auctions is superior to existing Chapter 11. One needs to ask if reforms are possible in which one can have the best of both worlds and ensure that early auctions take place when it is in everyone's interest, but not otherwise. In the next part, I examine the ways in which current law stifles auctions and should be changed even if one were of the view that those in control of the reorganization should be able to choose between a quick auction and a negotiated reorganization. In subsequent parts, I ask whether a mandatory auction regime would be preferable to this hypothetical one that nevertheless is built around a presumption that those in control of the reorganization should be able to create a new capital structure in which the old creditors and shareholders give up their old rights in the firm for new ones.

II.

A firm in Chapter 11 typically faces two conceptually distinct problems. First, decisions have to be made about how its assets are to be used. Firms in financial distress may have unsound business plans that need to be revised. Some assets may need to be sold and others acquired. Second, firms in financial distress need to untangle their capital structures. Firms rarely have neat capital structures in which the priority of claims is neatly set out. A secured creditor is entitled to a priority only to the extent of the value of its collateral. In many cases, however, it may be hard to value the collateral—such as the firm's plant and equipment—apart from the value of the firm as a whole. Publicly traded firms may consist of several interrelated subsidiaries, each of which has guaranteed the loans of the other. The priority of creditors is sometimes in doubt and sometimes subject to attack on fraudulent conveyance or equitable subordination grounds. There may be a large claim (such as a tax dispute with the IRS or a mass tort claim) that leaves the relative entitlement of the creditors in doubt. Sorting out these issues requires litigation that, with trials and appeals, consumes a great deal of time.

The principal advantage of an auction is that it separates the two issues. Some ways of using a market mechanism to sort out the rights of the various players in Chapter 11 requires knowing how

as a going concern only if the current manager-shareholders are kept in place. Whether reorganized in bankruptcy or not, there needs to be an elaborate set of negotiations among parties with a past and future interest in the firm before it can get back on an even keel. An auction for these firms in Chapter 11 may simply shift an elaborate set of negotiations to a different forum.

The remaining group is the one of concern to us. This one contains those firms that are publicly traded. In terms of sheer numbers, the other two groups dwarf this one. In the first seven years of the 1978 Bankruptcy Code, only 99 firms out of the tens of thousands filing for Chapter 11 protection were traded on the New York or American Stock Exchanges.⁹ On the other hand, the total dollars involved in these cases may equal or exceed those of the other two groups combined.¹⁰

There is a separation of ownership and control in the case of these firms. An individual shareholder may control a large fraction of the stock.¹¹ Nevertheless unlike the closely held firm, the ownership and operation of the firm are not intertwined and, even in a reorganization, the old equityholders can stay on as of right only by putting in new cash. An auction, like a negotiated reorganization, gives them an opportunity to remain in control if the assets are in fact worth more in their hands than in anyone else's? It may be necessary to give managers stock options and the like to give them the right set of incentives, but the value of these options is small given the overall capital structure of the firm. These cases are not ones in which the equity interest will naturally gravitate back towards those who currently own the stock.

⁹ See Weis, *supra* note 3, at 286-88.

¹⁰ See Flynn, *supra* note 7, at 18-19. Flynn reports that 67% of all payments in his sample came from firms with \$100 million in assets or more. A substantial fraction of these (in fact more than half), however, were payments made in a single case (Johns Manville)

¹¹ See Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 *J. Pol. Econ.* 1155 (1985).

¹² For an argument using the similarity between auctions and negotiated reorganizations as a justification for the latter, see Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 *Stan. L. Rev.* 69 (1991).

much each creditor is owed and what priority that creditor enjoys.¹³ These mechanisms cannot disentangle the running of the business from disputes over rights to the assets. A public auction, however, does not require the resolution of any of these disputes. There can be an auction of the assets and the proceeds can be placed in escrow. The new owners of the firm can put the assets to their best use and the competing creditors and shareholders can fight over the proceeds.

Under current law, however, courts resist conducting a sale separate from the rearrangement of the financial structure. The practice that has emerged under the 1978 Bankruptcy Code has been to treat both the question of how to use the assets and who owns them together. The burden is on the party that wants to conduct an immediate sale to offer a business justification for selling the assets? This interpretation of the Bankruptcy Code is easy to defend. The provision of the Bankruptcy Code dealing with the sale of assets during the bankruptcy case was never designed to oversee the sale of the entire firm. There are no procedural protections other than a requirement that notice be given to affected parties and that they be given a chance to appear before the bankruptcy court if they object.¹⁵ There is no formal mechanism to ensure that the sale does not disadvantage the diverse creditors and other interest holders who may not individually have enough at stake to object. By contrast, the plan confirmation process provides for extensive disclosure to all affected parties and gives them a chance to vote. The Bankruptcy Code's procedural protections are focused around the plan confirmation process and courts are naturally wary of any course that would short-circuit them.

In this environment, auctions are unlikely to take place. It is bound to be in the interest of someone to demand that everything take place at the time the plan is confirmed. It takes only one shareholder who will be left out of the money if there is an imme-

¹³ See, e.g., Lucian A. Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775 (1988).

¹⁴ See *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983). For a discussion of the case law, see Douglas G. Baird, *The Elements of Bankruptcy* 225-29 (Foundation Press 1992).

¹⁵ See 11 U.S.C. §363.

diate sale to register an objection. Hence, under current law, having an early auction also means having an early confirmation of a plan of reorganization. There are, of course, cases in which determining the priority of and the amount owed to each creditor is straightforward. The Chapter 11s in which there is a "prepackaged plan" are often cases in point. A plan of reorganization can be put forward virtually the day the petition is filed and the confirmation may take place within a few months.¹⁶ These cases, however, are the exception. Disputes over valuation and priority typically arise and, like most corporate litigation, these disputes will take time to work their way through the courts. As long as the sale of the assets is tied to the sorting out of competing claims to the firm, a speedy public auction is not likely to take place. Let us assume, however, that Chapter 11 could be reformed and sufficient procedures could be put in place to protect dissenters and still allow those in control to conduct an early auction when they thought it was in everyone's interest.

In addition, let us also assume that we can eliminate some of the more conspicuous agency problems that exist under current law. Bankruptcy lawyers and other professionals now wield significant power in Chapter 11 cases. They have little incentive to bring cases to an early close. To prevent abuses, courts have required bankruptcy professionals to keep elaborate records and compensate them according to the amount of time they work. To the extent that a firm suffers losses simply by virtue of being in bankruptcy, this kind of compensation structure may not make sense. It is harder to craft the right set of rewards in a system that relies on a hypothetical sale back to the old owners. A set of rules might exist that rewarded bankruptcy professionals for bringing about a quick auction when it was in everyone's interest, even if the Bankruptcy Code were not amended to mandate such an auction.

There are also a number of ways in which the incentives of the managers are skewed away from inducing them to bring a quick auction. For example, the loyalties of those who are running the sale

¹⁶ The procedures that the Bankruptcy Code requires, however, especially its notice provisions, may be quite burdensome when ownership interests are publicly held. For example, one must account for votes by individual creditors, even when the securities are held in street name. See *In re Southland Corp.*, 124 Bankr. 211 (Bankr. N.D. Tex. 1991).

could be better defined. The general principle that the managers of a firm in Chapter 11 have a duty to maximize the value of the estate is not clearly established.¹⁷ Under existing law, managers are too free to advance the interests of those, such as the equityholders of insolvent firms, that are no longer the residual owners of the firm. Defining their fiduciary duty more explicitly and providing sanctions if they violate it (as does English law¹⁸) may do much to ensure that they take everyone's interest to heart when they decide whether to have an early auction or a consensual reorganization.

Existing law does not take the time value of claims into account to nearly the extent that it might. This compounds the problems that exist when the managers are beholden to junior parties. Failing to take time value into account in valuing senior claims systematically favors junior parties. In addition, the current legal regime discourages firms from selling assets in Chapter 11 in other ways. Most conspicuously, sales to third parties are likely to receive less favorable tax treatment than reorganization in which the old owners remain, but with a different set of rights. Let us assume, however, that these problems could be overcome without mandating auctions. The question to which I now turn is whether mandatory auctions would bring substantial benefits even after these reforms.

III.

The heart of the debate over auctions in Chapter 11 turns not on whether auctions may sometimes be desirable, but rather whether the freedom of choice of those in control should be curtailed. The argument against curtailing their choice begins with the assertion that the direct costs of bankruptcy are relatively small. In addition to resolving disputes among creditors, a Chapter 11 plan of reorganization is a complete recapitalization of the firm. Its market-place equivalent is an offering of all the debt and equity of the firm at the same time. For publicly traded firms in Chapter 11 in the 1980s, these costs ranged between .9 and 1 of the book value of the

¹⁷ Some courts, however, including the Seventh Circuit, have embraced this principle. See *Wabash Valley Power v. Rural Electrification Admin.*, 903 F.2d 445, 451 (7th Cir. 1990).

¹⁸ See Michelle J. White, *Corporate Bankruptcy: A U.S.-European Comparison* (manuscript 1991).

assets before the filing of the bankruptcy petition. The average was 2.8%.¹⁹ By contrast, the direct cash costs of initial public offerings for amounts greater than \$10 million were about 10%.²⁰ By this benchmark, the cost of recapitalizing a firm in bankruptcy appears to be substantially less than the cost of taking a firm public. A restructuring in bankruptcy may be more akin to a private placement. A large part of the costs of the initial public offering involve complying with the securities laws and these are not faced in Chapter 11. Moreover, an offering of equity by a firm that has never been publicly traded may be different from an offering of debt and equity of a firm that has been. Yet private placement of debt of even a large, well-known firm is not dramatically less, on a percentage basis, than the cost of a Chapter 11 reorganization. Moreover, the costs of Chapter 11 seem in line with the costs of leveraged buyouts of large firms that also involved reforming a firm's capital structure. To the argument that investment bankers could in principle sell securities in the reorganized firm, one can respond that, even if they could, a hypothetical sale inside of Chapter 11 is cheaper.

Even if the direct costs of Chapter 11 seemed high relative to the restructuring of firms that were not in financial distress, one has to focus on that part of the direct bankruptcy costs that a mandatory auction would eliminate and exclude the costs of resolving disputes among the various players that would exist even in a mandatory auction regime. Once all of this is taken into account, it is hard to support the case for mandatory auctions on the basis of the direct costs of bankruptcy. Instead, the case for requiring a speedy public auction

¹⁹ See Weis, *supra* note 3, at 289. One should note that the relative size of direct bankruptcy costs may be much greater in smaller cases. For a case in which attorney's fees by the parties exceeded the value of the assets, see *In re Pullman Construction Industries, Inc.*, 107 Bankr. 909 (Bankr. N. D. Ill. 1990). White, however, reports costs of a representative sample of all firms that successfully reorganize are only 3%. See Michelle J. White, *Bankruptcy Liquidation and Reorganization*, in Logue, Dennis, eds., *Handbook of Modern Finance*, chap. 35, pages 1-49 (Warren, Gorham & Lamont 1984). For a more general discussion, see Michelle J. White, *The Corporate Bankruptcy Decision*, 3 *J. Econ. Perspectives* 129 (1989).

²⁰ See Jay R. Ritter, *The costs of going public*, 19 *J. Fin. Econ.* 269, 272-73 (1987). Some of these cash outlays, however, may have been rents captured by investment bankers and not social costs.

must begin with the assumption that the indirect costs of bankruptcy are large and that, even with substantial reforms, those in control of the reorganization will not avoid them.

In the case of closely held firms, the indirect costs of bankruptcy are easy to identify. The shareholders are typically also the managers of the firm. Because of their firm-specific human capital, the firm may not have a future as a going concern without them. Bankruptcy judges are reluctant to terminate the exclusivity period or lift the automatic stay as long as it appears that the firm can in fact survive as a going concern.²¹ Hence in the case of these firms, the managers are in control.²² Moreover, their interests are allied with (and indeed indistinguishable from) the interests of the shareholders. Delay can only help the shareholders. If there is an immediate sale, the shareholders of an insolvent firm will be left out of the money. If there is a delay before the day of reckoning, the fortunes of the firm may improve and the shareholders may be left with something. Hence, these managers have an incentive to stretch of the reorganization process. The indirect costs of bankruptcy are often large because the managers may continue to run the firm as a going concern long after it should have been liquidated.

Indirect costs for large publicly traded firms are harder to identify. In most cases (Eastern being a conspicuous assumption), the firm will continue to do business as usual in bankruptcy and afterwards. Hence, we do not see those in control postponing a desirable liquidation. Those in control might have an incentive to make risky investments in the hope that they will be lucky and the firm will become solvent, but, as I have already noted, courts are reluctant to approve major changes outside the context of a plan of reorganization. The indirect cost of bankruptcy in the case of publicly traded firms result largely from inaction. A firm continues to do business as usual in Chapter 11. Bloomingdale's and Macy's look much the same

²¹ In the case of closely held firms, the exclusivity period itself does not matter much. What matters is whether the bankruptcy judge is either willing to lift the automatic stay or confirm a liquidating plan. See Douglas G. Baird & Randal C. Picker, A Simple Noncooperative Model of Corporate Reorganizations, 20 J. Legal Stud. 311 (1991).

²² Empirical study bears this out. See Lynn M. LoPucki, The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?, 57 Am. Bankr. L.J. 247, 266-69 (1983).

to their customers. Indeed, once they are in bankruptcy, they may look better because suppliers can ship goods with greater confidence that they will be paid. For many firms, however, simply preserving the status quo for two or three years will come at a large cost. A firm whose managers are preoccupied with a Chapter 11 reorganization may find itself lagging its competitors once the reorganization is over.

Costs such as these, however, are not easy to measure. One can compare the performance of firms in bankruptcy with similar firms outside, but it is hard to know if the differences stem from the indirect costs of bankruptcy or to the underlying differences between the firms that led one of them to file a bankruptcy petition in the first place. An opportunity to assess the indirect costs of bankruptcy came when the Texaco bankruptcy ended suddenly and much more quickly than anyone expected. Mnookin and Wilson argue that the change in the price of Texaco stock that took place at this time reflect in substantial part the market's guess at the expected saving from the shortening of Texaco's stay in bankruptcy.²³ The rise in the stock price was large. Indeed, the rise was so large (in the neighborhood of \$2 billion) that some suspect that something else was going on. For example, at the same time that the reorganization was coming to a close, there were indications that Texaco was "in play" and might be taken over. The rise in price may have been due to the possibility of a takeover rather than to saving from an early departure from bankruptcy. One simply cannot draw too many inferences from a data set of one.

Even if the indirect costs of bankruptcy were high, one would not want to mandate auctions if those in control could be trusted to weigh these costs against the costs of an early auction. Many assume that those in control cannot be trusted to make decisions that are in everyone's interests. The managers of publicly traded firms are entrenched and worry about their own interests and not those of the creditors and shareholders as a group. Empirical evidence, however,

²³ Robert H. Mnookin & Robert B. Wilson, Rational Bargaining and Market Efficiency: Understanding *Pennzoil v. Texaco*, 75 U. Va. L. Rev. 295, 312-15 (1989). See also David M. Cutler & Lawrence H. Summers, The costs of conflict resolution and financial distress: evidence from the Texaco-Pennzoil litigation, 19 RAND Journal of Economics 157 (1988).

suggests that one must be cautious about reaching such a conclusion too quickly. This evidence suggests that the senior managers of publicly traded firms in financial distress typically lose their jobs. For example, fewer than 10% of the CEOs in place 18 months before the filing of the petition are still around at confirmation of the plan (which takes typically takes place 2 or 3 years after the filing of the petition). Indeed, almost half of those hired to replace them were ditched as well.²⁴ In short managers at these firms are not entrenched. To say this, however, is not to say that the managers are pursuing the interests of the firm as a whole, only that they are likely to be pursuing the interests of those who have the power to control them. Although the creditors' committee and the postpetition lender be able to exercise control indirectly, the shareholders nominally continue to control the managers and managers, at least in some cases, openly embrace the idea that their duty lies with the shareholders.²⁵

Moreover, the monitoring mechanism that exists in bankruptcy is necessarily much cruder than the one that exists outside. The automatic stay prevents creditors from using the powers given them in loan covenants. The power of the shareholders to control the managers may be reduced as well given the power of the bankruptcy court to enjoin meetings of shareholders.²⁶ During a reorganization in which there are competing interests that are diversely held, much of the control rests with the bankruptcy judge. The judge's relative inability to monitor the firm would take away from the managers any pressure to conduct an early sale. Hence, one can argue that, even if managers do not have the equivalent of tenure, they do not have an incentive to expedite matters either. Given that the sale is more likely to end their jobs than the alternative course, it is not one

²⁴ See Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganizations of Large, Publicly Held Companies* (manuscript) (December 1991). See also Stuart C. Gilson, *Management Turnover and Financial Stress*, 25 *J. Fin. Econ.* 241, 248 (1989). Gilson suggests a smaller, but still substantial turnover rate for the managers of distressed firms.

²⁵ See LoPucki & Whitford, *supra* note 24.

²⁶ See *In re Johns Manville Corp.*, 801 F.2d 60 (2d Cir. 1986).

that they would favor in the absence of some pressure.²⁷ Some have argued that the inability to find someone whose interests are allied with the owners as a group makes it hard to have an auction that will obtain top dollar, given that the timing of the auction itself requires discretion.²⁸ This argument, however, proves too much. As hard as it may be for a bankruptcy judge or someone else to conduct an auction, these difficulties pale beside the task of monitoring the ongoing business decisions of a large, publicly traded firm. The case for a quick auction is made stronger, not weaker, if there is no single agent of the residual owner to make decisions.

The managers in a individual case might not pursue an early auction if given the choice even if they were perfect agents of the owners of the firm and even if the indirect costs of bankruptcy were substantial.²⁹ An auction might not be sold for an amount that reflected their full value. A firm's prospects may not be equally well known to all the players. It may be that the person that controls the timing of the auction is systematically better informed than anyone else about how the uncertainty will resolve itself. Assume, for example, that half of the firms have a 75% chance of being worth \$200 and a 25% chance of being worth \$100. The other half have only a 25% chance of being worth \$200 and a 75% chance of being worth \$100. The person controlling the sale knows what kind of firm is being sold, but has no way to communicate this information to anyone else. In the case of the second kind of firm, the person in con-

²⁷ Bradley and Rosenzweig compare bankruptcy filing under existing Chapter 11 with the legal regime in place before 1978 and suggest that the current regime in fact benefits managers at the expense of the other players. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 *Yale L.J.* 1043 (1992). One must, however, be reluctant to rely too heavily on their empirical findings because, as they recognize, the differences between the kinds of firms that filed for bankruptcy under the two regimes make the comparisons hard. The old regime, for example, may have allowed the managers of similar firms to capture as much wealth, but the firms that filed under the old regime might have been so far gone that there was simply less for their managers to appropriate.

²⁸ See, e.g., Easterbrook, *supra* note 5, at 415-16.

²⁹ The adverse selection argument that follows is, of course, a familiar one, being one of many variations on the standard "lemons" problem. See G. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 89 *Q.J. Econ.* 488 (1970).

trol might be willing to have an immediate auction, but the person controlling the first kind of firm would not as long as there was no way to convince third parties that it was a firm of the first **type** rather than the second. Because a third party buyer would never bid more than \$150 for the firm if there were an immediate sale, the person controlling the sale of the first type of firm would choose to wait until the uncertainty resolved itself. Taking a 25% percent chance of \$100 in return for a 75% chance of \$200 is much better than settling for a sale price of no more than \$150. Even if keeping a firm in Chapter 11 is costly and even if many business opportunities may be lost while a firm remains in reorganization, **firms** may nevertheless be forced to incur these costs if buyers drew the inference from the fact of an early sale that the fortunes of the firm were bleaker than they otherwise appeared.

The inability of those controlling the sale of good firms to distinguish themselves from those controlling the sale of bad firms may itself prevent speedy auctions from going forward in any legal regime in which having an auction is optional. Rental car companies are able to realize high prices on their used cars because they sell all of their cars after a certain period of time. The market for these cars is not like the ordinary market for used cars in which buyers fear ‘that only the ones that are lemons are being put on the market. Similarly, being able to realize a high price for firms in Chapter 11 at a quick auction might be possible only if all **firms** were sold.

The owners of good firms may be able to devise some mechanism to distinguish themselves from the bad firms at an immediate auction. Their own willingness to bid at the auction would, for example, itself communicate **information**.³⁰ A legal rule that required a speedy sale of all firms, however, would avoid the loss that now can arise. If third parties assume that a firm that is sold quickly is a bad firm, good **firms** must stay in bankruptcy until third parties can ascertain their value. If delay is costly, owners of good and bad firms would be collectively better off from an immediate sale. To be sure, those firms that were likely to do well might be sold for the same as those that were likely to do poorly, but everyone might be better off over the long run. In short, even if the parties wanted a speedy auction, they might nevertheless find in their interest to wait if they

³⁰ See Markell, *supra* note 12, at 107-11.

knew their firm would likely enjoy a bright future, but had no credible way of convincing potential buyers except by waiting for the future to come.

IV.

As long as the question of the indirect costs of bankruptcy remains unknown or hovers in some intermediate range and the costs of monitoring those running a firm in Chapter 11 do not seem overwhelming, the debate over early auctions in Chapter 11 is likely to focus on the costs that the early auction itself brings. Some of the objections to early auctions seem unfounded. One objection focuses on the potential loss of the “bust-up” premium.³¹ Assets of firms in financial distress often should not stay in the same configuration. The process of finding buyers for each of the pieces takes time but brings a “bust up” premium that some think will be lost if there is a single auction in which all the assets are sold at once (even if they are not sold as a unit). An immediate auction, however, in which there is competitive bidding should not squander the “bust up” premium. The bidders at the auction will take into account the amount for which they will realize either from using the assets themselves or selling them. In a competitive auction, the buyer will enjoy only a return on its entrepreneurial skills in knowing how to divide up assets and how to find buyers. Many of those involved in a bankruptcy reorganization, including managers hired as “turn-around artists” after the filing of the petition might prefer to employ their own entrepreneurial skills. Realizing the highest dollar value from the sale, however, does not require that the sale of the assets take place over time. As long as the auction itself is a competitive one, the eventual gains from breaking up the assets will be reflected in the sale price.

Some argue that uncertainty itself will dampen the bidding at an early auction. A firm in financial distress faces an uncertain future, but this fact alone does not mean the winning bidder will pay less than the firm’s true value. Firm may be worth \$200 or \$100 depending upon the course of future events. Risk neutral buyers in a competitive auction should be willing to pay \$150 for it. Half the time, someone will, in retrospect, acquire Firm for a bargain price, but

³¹ See LoPucki & Whitford, *supra* note 24.

only because in the other cases someone will pay too much. Uncertainty itself does not change the expected value. As long as both those who will enjoy the proceeds of the sale and the buyers at the sale are risk neutral, they will be indifferent between \$150 today or a fifty-fifty chance of \$100 or \$200 in the future. Even if both the creditors and the buyers are both risk averse, uncertainty is an argument against a speedy sale only if the buyers are apt to be more risk averse than the creditors. It does not seem on the face of it that those who control vulture funds or, more generally, those who are actively engaged in the market for corporate control are systematically more risk averse than creditors and shareholders generally.

Other potential costs of an early auction are harder to dismiss. The benefits of an early auction turn crucially on who comes and bids. Shliefer and Vishny point out that when one firm in an industry suffers from financial distress, other firms in the same industry may suffer from distress as well. Even if they are not themselves in reorganization, their own financial condition may keep them from entering the bidding. In Shliefer and Vishny's model, the price the creditors realize at an auction may not only be low, but also the winning bidder may not be the person who values the asset the most. The winning bidder waits for some period of time and then sells the assets to someone with expertise in the industry after economic conditions change.

The possibility that the winning bidder may hold the assets for a period of time and then resell them is not alone dispositive. Indeed, at the time of the loan, the creditors might not object to a sale on these grounds even if they would realize more if they were hold on to the assets, incur substantial bankruptcy costs, and then sell to the same ultimate buyer. The standard assumption that the optimal rule was one that ensured that the Chapter 11 proceeding was run in a way that maximized the value of the estate is not self-evident. Just as shareholders of a firm may be better off *ex ante* if managers are not able to auction the firm once there has been an initial **bidder**,³² the

³² Daniel Fischel and (ironically in this context) Frank Easterbrook are best known for this point. For their latest views on this issue, see Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 162-211 (Harvard University Press 1991). See also Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 *J. Legal Stud.* 165 (1988). For

creditors and other interested parties may prefer ex ante a speedy sale at a lower price that puts the assets to their highest valued use. This course is preferable if a subsequent sale at a higher price comes only after significant bankruptcy costs are incurred. These costs are a deadweight social loss that the parties, before the fact, would want to avoid.³³ This issue parallels one that triggered much of the takeover debates in the 1980s. If delay in bankruptcy brings with it costs that are a dead-weight social loss, an investor with a diversified portfolio might prefer that a firm be sold quickly even if it were not being sold for top dollar.

Shliefer and Vishny, however, identify an additional problem that can arise when an industry's debt capacity chills the bidding at an auction: The assets spend some amount of time in the hands of someone who cannot make the best use of them.³⁴ The winning bidder not only pays too little, but is not someone who values the assets as much as the existing creditors and shareholders. The value lost while the assets are in the hands of the winning bidder may exceed the direct and indirect costs of bankruptcy. Their argument, however, suffers from two weaknesses as applied to publicly traded firms. First, while the problem of debt capacity may loom large in some cases, it should not loom large in the case of publicly traded firms. In these cases, there is a substantial separation of ownership and control. The creditors and the shareholders for the most part hold diversified portfolios and have no special expertise with respect to the industry in question. The winning bidders must find managers who are adept at running the firm, but finding such managers

an alternative view, see Lucian Arye Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 *J. Legal Stud.* 197 (1988).

³³ The question of linking bankruptcy rules with the more general problem of capital structures and ex ante incentives has been a focal point of recent bankruptcy scholarship. Randy Picker's work has done the most to draw attention to it. See Randal C. Picker, *Security Interests, Misbehavior, and Common Pools* (University of Chicago Working Paper No. 5, 2d Series, February 1992); Lucian Arye Bebchuk & Randal C. Picker, *Bankruptcy Rules, Entrenchment, and Human Capital* (manuscript November 1991); Robert Gertner & Randal C. Picker, *Bankruptcy and the Allocation of Control* (manuscript February 1992).

³⁴ See Andrei Shliefer and Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach* (manuscript December 1991).

should not be harder when the firm is in an industry that is going through an economic downturn. If anything, it should be easier. In any event, the winning bidders can at least match the performance that the firm would have in bankruptcy by retaining the current management. The winning bidders may be able to put the assets to better use and they should not put them to worse use.

Second, their analysis is most apt for firms that are experiencing financial distress, but which otherwise have sound business plans. In many cases, firms in Chapter 11 need new business plans. Divisions need to be sold off and out-dated factories need to be shut down. The expertise that is needed is not necessarily that of managers with skills particular to the industry, but rather with skills peculiar to firms in distress. Having the firm in the hands of someone who would own it only through a period of distress may be a good thing, rather than a bad thing. An auction makes it easier for a **firm** to be in the hands of a wartime general during a transitional period.

The large leveraged buyouts of the **1980s** as well as the active market in corporate control show that the size of these publicly traded firms in bankruptcy does not itself prevent the requisite amount of capital from being assembled. (One needs only bear in mind that the existence of this takeover market in the case of Texaco, the largest firm ever to enter Chapter 11, was what made measuring the indirect costs of its bankruptcy suspect.) In recent years, there has been much more active trading in the debt of firms in Chapter 11. In one case, there was in fact a tender for the debt of the firm. In many auctions, however, the owner of the asset not only controls the timing of the auction, but also sets a reservation price. A rule mandating a quick auction bypasses these. What ultimately ensures that creditors will realize the most from the assets, however, is active competition among bidders, especially among those whose expertise lies in breaking firms up. More people with such expertise would surely exist in a world in which one could acquire firms without settling all the battles among its owners than exists in our world, but whether enough people would exist to create an active market among the dozen or so cases that arise each year is not clear.

Gertner and Picker have identified a different barrier that might prevent assets from being put to their highest valued use after an

early auction.³⁵ Immediately after a firm enters Chapter 11, potential bidders may not be able to tell how much the firm is worth or what must be done with its assets. Determining what should be done with assets turns crucially on the kinds of cash flows assets can generate in their current use. Learning this information may be hard immediately after a firm has entered bankruptcy. The managers of distressed firms pick and choose among their creditors. Squeaky wheels get greased. Short-term creditors may be favored over long-term creditors. The managers may buy less than they need from suppliers who are vigilant and more from those that are not. Assets cannot be put to their highest valued use until the dust settles. Chapter 11 offers a “breathing space” in which third parties can observe the firm’s cash flows without the distortions that accompany financial distress outside of bankruptcy. Gertner and Picker suggest that mandating an early auction may force third parties to bid on the firm without knowing what its assets are worth or even whether they should be kept together. The winning bidder must sort out the affairs of the firm. To be sure, after he determines what to do with the firm, he can then sell it to the person who in fact can put it to its best use. In this event, however, the winning bidder does exactly the same thing that takes place in Chapter 11.

The Gertner-Picker model has two important implications for analyzing auctions in Chapter 11. First, one cannot compare the direct costs of a bankruptcy reorganization with the direct costs of an early auction. An auction may need to be followed by a subsequent sale. By contrast, a plan of reorganization may put the assets to their ultimate use as soon as it is implemented. Hence, the cost of both the auction and the subsequent sale must be compared with the direct bankruptcy cost. Second, in assessing the magnitude of indirect bankruptcy costs, one must isolate those costs that are incurred only in a bankruptcy regime. If the successful bidder does not know what direction the firm should take until he can see the firm operate without its cash flows being juggled about, he may be forced to continue the status quo, much as is now the case in Chapter 11. The firm may stagnate-regardless of the legal regime. To be sure, those in control of a firm in Chapter 11 have an incentive to incur

³⁵ See Picker & Gertner, *supra* note 33.

these costs longer than necessary, and a successful bidder does not. This difference, however, may not be a large one.

Gertner and Picker's model may force a shift in focus. Much of the debate has looked at the relative advantages of mandatory auctions and negotiated reorganizations without asking how the firm got into Chapter 11 in the first place. This view is too myopic. One only knows how well a set of reforms inside of bankruptcy will work after one understands how they will affect the way parties behave before bankruptcy. One cannot expect the same parties to file a Chapter 11 petition at the same time they file now if the filing triggered an immediate public auction. Just as managers will do much outside of bankruptcy to resist hostile takeovers, they may well be reluctant to begin a bankruptcy process that will lead to an auction that is the functional equivalent of a hostile takeover. A Chapter 11 regime in which auctions were the rule of the day is not going to be one that managers of troubled firms will embrace with much enthusiasm.

The question that needs to be asked is whether the creditors can fill the role that managers now play in putting the firm into bankruptcy. If, as in the Gertner-Picker model, the creditors are not well informed and the managers can keep bad news from them by manipulating cash flows, then there may be no one that puts a firm in bankruptcy and, even if there were, a bankruptcy with a mandatory auction would bring few benefits because the successful bidder would have to mark time, unscramble the affairs of the firm, and incur the same direct and indirect costs that we now see in bankruptcy. On the other hand, if creditors are able to monitor the firm and are not misled by the managers' manipulation of the cash flows, then we may count on them to file bankruptcy petitions. They do not need a "breathing space" to figure out what to do with the firm's assets. The prospect of an early auction might also change the dynamics of workouts outside of bankruptcy for the better. Recalcitrant creditors who now would throw procedural obstacles in the way of a reorganization would have much less of an incentive to resist a workout if the 'day of reckoning in bankruptcy came quickly and predictably. A quick auction may serve the same function as a baseball arbitrator. Parties may be more likely to narrow their differences and reach agreement if they knew that, in the absence of agreement, their rights would be measured by a market baseline.

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