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The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms

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THE HIDDEN VIRTUES OF CHAPTER 11: AN OVERVIEW OF THE LAW AND ECONOMICS OF FINANCIALLY DISTRESSED FIRMS

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I. THE DISTINCTIVE ATTRIBUTES OF CHAPTER 11

Chapter 11 shares many of its features with legal regimes in other jurisdictions. Nevertheless, Chapter 11 gives managers of a financially distressed firm an unparalleled ability to control the reshaping of the firm's capital structure.[1] The managers of financially distressed firms are the ones who typically begin the Chapter 11 process.[2] Once the process is begun, the debt-collective efforts of all creditors—including secured creditors—must cease. Payments to creditors cease as well. The managers continue to run the day-to-day operation of the business. With court approval, they can borrow new funds and give these funds a priority over existing general creditors.[3] In most cases, the managers also control the process of reorganization and are the only ones entitled to present a reorgani-

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[1]In principle, the managers' fiduciary duty shifts to the creditors when a firm becomes insolvent. See, e.g., Geyer v. Ingersoll Publications Co., 621 A.2d 784 , 787 (Del. Ch. 1992); Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 976–77 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983) ("[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."). In practice, however, the managers suffer no penalties for delaying a bankruptcy, in distinct contrast to some European jurisdictions. See White (1993).

[2]This assertion must be qualified. Involuntary filings are possible, see 11 U.S.C. §303, but in practice they are rare. More significantly, a creditor may push the managers into Chapter 11. (For example, the secured bank lender may threaten to call on a personal guarantee if the managers do not file.) Even here, however, the managers retain control over the timing of the decision.

[3]The managers are known collectively as "the debtor in possession." Hence, these loans are known as "debtor-in-possession" financing or, more colloquially, "dip" financing. See 11 U.S.C. §365.

zation plan to the court.[4] In many cases, the reorganization takes several years. The reorganization plan can be confirmed over the objection of general and secured creditors. As long as creditors holding one class of impaired claims votes in favor of the plan, the rights of all the other creditors can be readjusted over their objection as long as various provisions of the Bankruptcy Code are satisfied.[5]

We can find other jurisdictions in which managers possess one or more of the powers they enjoy under Chapter, but not all of them.[6] The scope of the powers of the managers of a financially distressed firm sets Chapter 11 apart. The ambition of any law of corporate reorganizations is to prevent efforts to reorganize firms that ought to be liquidated and promote efforts to reorganize firms that are viable going concerns.[7] For the last 15 years, law and

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[4]Section 1121 provides that the managers have presumptively four months to submit a plan of reorganization and an additional two months to gain acceptance of a plan once it is submitted. In practice, however, the period is routinely extended as long as the bankruptcy judge is unwilling to allow the secured creditor to seize the firms assets and liquidate them. "Lifting the automatic stay" and terminating exclusivity typically amount to the same thing. A bankruptcy judge is rarely inclined to do either if the firm continues as a going concern and the debtor is making a good faith effort to resolve disputes among different creditors and draft a plan that they will support. The typical plan, once proposed, is amended a number of times.

[5]These protections collectively are known as "the absolute priority rule." The process of imposing a plan over the objections of creditors holding a class of claims is known as "cram down." See 11 U.S.C. §1129.

[6]Canadian law gives managers less time to put a reorganization plan in place and they lack the power to "cramdown" a plan over the objection of a class of creditors. See LoPucki & Triantis (1994). A look at Japanese law tells a similar story. See Eisenberg & Tagashira (1994). Unlike Chapter 11, the Japanese composition proceeding does not have as sweeping the automatic stay in §362 of the Bankruptcy Code and secured creditors have a much greater ability to reach their collateral. See Composition Act §43. In addition, an examiner is appointed at the outset of a case to review the debtor's financial condition and advise the court about whether the case should proceed. Composition Act §21. By contrast, in the typical Chapter 11, there is no outsider to investigate the case and a review of the debtor's suitability for reorganization comes only later, if at all, when a creditor brings a motion to lift the automatic stay.

[7]Eisenberg & Tagashira (1994), LoPucki & Triantis (1994), and White (1993) each offer comparative law approaches to Chapter 11 that focus on the balance between ensuring that firms that should be liquidated are liquidated on

economics scholars have focused on the question of whether Chapter 11 and its bias in favor of trying to preserve firms as going concerns makes sense.

The starting place for thinking about the law governing firms in economic distress has been the idea of "the investors' bargain."[8] The law of corporate reorganizations, like corporate law more generally, rests upon a network of contracts. We are all better off if we make it easy for entrepreneurs to start firms. They will be able to do this only if they can find capital. Capital is most available if investors can enter into contracts with these entrepreneurs and be confident that they will be enforced according to their terms. The law should provide investors and entrepreneurs with the set of terms for which they would have bargained had transaction costs been sufficiently low.[9] Like the rules of corporate law, the law of corporate reorganization should be the default terms for which parties would bargain most of the time. Hence, the challenge that defenders of Chapter 11 face lies in explaining why rational investors and entrepreneurs would, before the fact, want such a legal regime.

This approach to Chapter 11 is strikingly different from that of traditional academics and many of its practitioners. These scholars, judges, and lawyers usually give lip-service to the absolute priority rule and the need to recognize the rights for which the creditors bargained. They go on, however, to argue that it is only one of many values that Chapter 11 protects. Just what these other values are is not always clear. Sometimes they seem to boil down to no more than assertions that misery loves company and everyone should "share the hurt."

These values may reflect a distinctive characteristic of United States law, which has always been solicitous of debtors. The first

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the one hand and ensuring that viable firms remain as going concerns on the other.

[8]Jackson (1982) gives this idea its definitive formulation.

[9]This formulation puts to one side obligations owed to tort victims and other involuntary creditors. Law and economics scholars have not ignored this problem. See, e.g., Roe (1984); Jackson (1986). Such obligations, however, do not loom large in the capital structure of most firms. In any event, the investors' bargain model proves a useful tool in sorting through the kinds of issues that these obligations raise. See, e.g., In re CMC Heartland Partners, 966 F.2d 1143 (7th Cir. 1992).

settlers of Georgia were themselves exiled debtors. During the colonial era, creditors could not levy on real property in Virginia. Even today, creditors can not levy on an individual's homestead in Texas, defined to include both the dwelling and the acre surrounding it. For whatever reason, however, many traditional scholars have not accepted the paradigm with which most law and economics scholars have begun and have shown little interest in their work beyond attacking the first principles on which it rests.[10]

This paper focuses on the light that law and economics has shed on Chapter 11 and the problem of firms in financial distress. It is worth noting that this paper does not concern itself with the vast majority of cases in the Chapter 11. Chapter 11 is often a way station for firms that have ceased to operate as going concerns and need to wrap up their affairs.[11] In addition, many cases in Chapter 11 are single-asset real estate cases. An office building is owned by a group of passive investors.[12] A management company handles the day-to-day operations, such as maintaining the building, finding new tenants, and collecting the rent. If the real estate market collapses and the rental income from the property no longer can meet the debt service, the bank that holds the mortgage may threaten to foreclose. Chapter 11 may be an attractive option to the passive investors.[13] Other cases involve firms whose outlook is so bleak and whose obligation to a single secured creditor is so large that Chapter 11 only postpones the secured creditor's seizure of all

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[10]For a flavor of the approach that traditional bankruptcy scholars have taken, see Warren (1987). These scholars also attack the methodology of the law and economics scholars. In their view, the law and economics approach is too reductionist, it fails to acknowledge market imperfections, and it focuses on problems, such as the restructuring of giant corporations, that are only a small part of the relevant universe. See Bufford (1994).

[11]It might seem that there would be a state law procedure so that such corporations, which are creatures of state law, could dissolve under state law. Such laws never developed in the United States, perhaps because Chapter 11 handled them effectively

[12]In the 1980s, these investors were often individuals with high disposable incomes (such as doctors, dentists, and lawyers) looking for ways to shelter income from federal taxation.

[13]State laws governing the foreclosure on real property may be particularly Byzantine. In addition, the investors may face particularly bad tax liabilities from a state foreclosure relative to the ones they face in Chapter 11.

the firm's assets. Finally, individual debtors may file Chapter 11 petitions.[14] The financially distressed firms on which we are focusing may be no more than 10% of all the Chapter 11 cases that are filed.[15]

The law and economics scholars who have studied corporate reorganizations have given the debate about the virtues hard edges in two ways. First, a number of scholars have proposed concrete alternatives to Chapter 11, and a number of others have subjected both Chapter 11 and the alternatives to close empirical scrutiny. I introduce this literature in Part II and review it in Part III after setting out a typology of firms in financial distress. Scholars are close to closure in understanding how well Chapter 11 works in the case of the large, publicly traded firm with a simple capital structure that faces only financial distress, but not economic distress. Much work, however, remains to be done in other types of cases.

Part IV shows that investors in the United States today can opt out of Chapter 11 if they choose, but that they often do not. From this observation, I argue that we may be able to draw the inference that Chapter 11 possesses hidden virtues. Part V begins with the premise that the benefits of Chapter 11 can be gleaned from an examination of its origins. It reviews how Chapter 11 evolved out of the equity receiverships used to reorganize railroads in the 19th Century.

This review of Chapter 11's origins leads me to suggest in Part VI that the benefits of Chapter 11 may not lie in its ability to overcome collective action problems or the problems of illiquidity that keep markets from working effectively, but rather from the way in which it overcomes two obstacles facing those who have invested in financially distressed firms: (1) their inability to gather information about the firm; and (2) the need to resolve disputes about the ownership of the firm's assets before a new capital structure can be put in place. The paper concludes with the observation that the

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[14]Such cases are often ones in which the manager-owner of a financially distressed firm enters Chapter 11 at the same time as the firm because of a personal guarantee that the manager-owner has made covering the firm's obligations to an institutional lender.

[15]See Flynn (1989). In the face of evidence that suggests that most Chapter 11 cases do not involve financially distressed firms at all, some have argued that Chapter 11 is an excellent way to liquidate firms. See Bufford (1994).

largest challenge facing law and economics scholars may lie not so much in discovering whether Chapter 11 provides net benefits relative to the alternatives, but rather in unbundling Chapter 11's many features and understanding which ones work and which ones do not.

II. ALTERNATIVES TO CHAPTER 11

The most obvious alternative to Chapter 11 is an outright sale of the firm's assets to the person who bids the most for them.[16] Instead of overseeing bargaining among different groups of creditors, the bankruptcy judge's primary task is to find an auctioneer. As long as the market is liquid, the assets end up in the hands of their highest-valued user and creditors and other investors are paid according to the absolute priority rule. The sale can take place even if there are the disputes among the creditors. (The proceeds of the sale can be held in escrow until the bankruptcy judge resolves the dispute.) This approach ensures that disputes about who owns the assets are neatly separated from the question of how they are used.

There are at least three theoretical objections to auctions. First, nothing under current law prevents an interested party from asking the judge to hold an auction. Indeed, such auctions have been held in Chapter 11 cases and have meet with conspicuous success.[17] Arguing that auctions should replace Chapter 11 is in fact an argument for *mandatory* auctions and must rest on the idea that investing judges with discretion in individual cases is a bad idea.[18] Market sales are generally better than hypothetical ones, but this does not itself make the case for eliminating Chapter 11, given that Chapter 11 currently allows market sales if the parties want it.

In addition, there are reasons to think that market for financially distressed firms will not be liquid, at least when there is private information.[19] Not only will creditors receive less than they would in a reorganization, but the high bidder might not be the highest-value

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[16]This alternative is commonly described as an "auction," although it need not take the form of the traditional English auction. See Baird (1986).

[17]The case of FNN is perhaps the best known. See Rackham (1991).

[18]See Easterbrook (1990). I suggest why mandatory auctions might make sense in Baird (1993).

[19]See Gertner & Picker (1992).

user of the asset. Such situations are especially likely to arise when the firm is in a depressed industry.[20]

Finally, mandatory auctions put discretion in the hands of a bankruptcy judge or someone else who does not have a financial stake in the outcome. An auction can take many forms, ranging from a traditional English auction to something resembling an initial public offering. Ordinarily, the person who decides how the auction is to be conducted is the residual owner of the assets. When a firm is financially distressed, however, the identity of the residual owner may not be clear and, even if it is, the residual owner may be a group of diversified creditors who have no way to act as one. A number of scholars have suggested reforms of Chapter 11 that try to introduce market mechanisms into the law of corporate reorganizations and still avoid the deficiencies of mandatory auctions. The two most important are proposals of Bebchuk and of Aghion, Hart, and Moore.

Bebchuk suggests that a recapitalization of a financially distressed firm be implemented through the issuance of options. Upon the filing of a bankruptcy petition, the most senior investors receive equity interests in the firm and junior investors receive options. The options are structured to ensure that the options are worth exercising only if the value of the firm is greater than what is owed all the investors with claims senior to the person exercising the option. Assume that we have a firm whose value is uncertain. A senior creditor is owed $100, a hundred junior creditors are owed $1 each, and a hundred investors hold the firms equity. Under Bebchuk's scheme, the senior creditor is given 100 shares of stock. Each junior creditor has the option to buy a share of stock from the senior creditor for $1. Each equityholder has the option to buy a share of stock for $2.

If the firm is worth less than $100, junior investors will not exercise their options. This is the correct outcome. Under these facts, the senior creditor is the residual owner of the firm and should hold all the equity. If the firm is worth more than $100, but less than $200, the junior creditors will exercise their options, but not

[20]See Shleifer & Vishny (1992). Empirical evidence may bear this out. Those who buy assets from firms in Chapter 11 tend to be in the same industry. See LoPucki & Whitford (1993b) at 764.

the shareholders. The senior creditors will receive $100 and the junior creditors will own the firm. Again, this is the correct result. The senior creditor is paid in full and has nothing to complain about. Nor do the equityholders. The firm is insolvent if it is worth less than $200 and the junior creditors are the residual owners. If the firm is worth more than $200, the equityholders will exercise their options. All creditors are paid in full and the equityholders own the firm.

Bebchuk's elegant proposal avoids the expenses of a full-scale auction. Moreover, it accommodates the preferences of individual investors. If the junior creditors disagree about whether the firm is worth $100, those who think it is will exercise their options and those who do not will not. Finally, Bebchuk's approach overcomes some of the liquidity problems that a mandatory auction of the entire firm might generate. Even if there is no single person willing to buy the entire firm, Bebchuk's proposal may still ensure that the assets are sold for their full value. Equityholders and junior creditors who lack the resources to exercise the options can sell them to someone who does. Competition among these investors for the options ensures that they are priced fairly.

Bebchuk's approach, however, still does not overcome all liquidity problems. Managers may possess private information about the value of the firm and lack the resources to participate in the auction. Third party investors may have the resources, but not the information. Bebchuk's scheme also depends crucially, in a way that a mandatory auction does not, on knowing who the creditors are, their priority relative to each other, and the value of their claims.

Aghion, Hart and Moore have suggested an ingenious approach that, like an auction, takes advantage of the market, but, like Chapter 11, allows for the old managers to take the lead in restructuring the firm when the assets are worth more in their hands than in anyone else's. They too would give the most senior creditors the equity of the firm and allow those junior to them to exercise options along lines similar to Bebchuk. After this process identifies the residual owners of the firm, the process reaches its second stage. Anyone, including the old managers, may propose a plan of reorganization to the residual owners. The reorganization may be as simple as a cash bid for the firm, or it may be a detailed plan of reorganization in which the residual owners hold bonds and other debt instruments, while the old managers continue to run the firm. The plan might provide them with equity or give them options to acquire it. The residual claimants presumably will favor such a noncash bid when, but only when, the firm is worth more in the managers' hands than anyone else's.

The options are used only to identify a group that chooses among different reorganization plans. Therefore, those holding disputed claims lose relatively little as long as the different plans set aside a cash reserve or otherwise ensured that their claims were treated as well as those who were similarly situated. Given that the holders of the undisputed claims are deciding only what plan maximizes the value of the firm, they have no incentive to act contrary to the interests of those holding disputed claims.

This scheme also makes it possible for managers and others who might face liquidity constraints to acquire control when they are, in the view of the residual claimants, the highest valued users. This proposal, however, may still not take sufficient account of the problem of private information. As long as the old managers possess private information about the value of the firm, the residual owners may have no way of assessing the value of a noncash bid.

III. A TYPOLOGY OF FINANCIALLY DISTRESSED FIRMS

Firms in financial distress are radically different from one another. Any discussion of the relative merits of Chapter 11 and other regimes must take these into account. There seem to be three characteristics that set financially distressed firms apart from one another.[21] First, we want to know something about the size of the firm, the composition of the investors, and the degree and separation between owners and managers. In Chapter 11, we see the large, publicly traded firm in which managers own only a small sliver

[21] A formal model of the costs of different corporate reorganization regimes could be based upon this typology. Some empirical data might have to be gathered, however, to assess the relative costs of different regimes for the different types of firms. There are a number of complications. The distribution of different types of firms will itself vary with the legal regimes. We should, for example, expect more firms with complex capital structures in a legal system that can sort out the rights of different investors at low cost. One can also argue that this typology does not take sufficient account of private information.

of the equity to the small firms in which the managers hold virtually all the equity.

Second, we need to know the firm's economic distress (whether its assets are being put to their best use) as opposed to its financial distress (whether it can meet its obligations to its investors).[22] A firm might be liable in tort for injuring thousands of individuals from a product it ceased selling decades before. This firm might be hopelessly insolvent and have liabilities vastly in excess of its assets. Nevertheless, there may be no problems with the ongoing operations of the firm. The firm's only problem is financial distress, not economic distress. There is no need to change its operations. At the other end of the spectrum is a business, such as a restaurant that has no customers. The firm may have no value as a going concern. If it is to survive, it must radically change the way it does business, starting perhaps with a new chef.

Third, firms in financial distress have different kinds of capital structures. Some firms have ones that make it a simple matter to identify how much each investor is owed and what priority each investor enjoys relative to all the others. Other firms have complex capital structures. These are firms whose owners are hard to set out on a traditional balance sheet. Obligations may be disputed or tangled with its operations in a way that makes them hard to identify. Obligations owed the government as a result of environmental regulations are good examples.

Even firms with seemingly straightforward balance sheets may have complex capital structures. Consider, for example, a firm that is in financial distress because of a leveraged buyout. The bank that financed the transaction asserts that it has a senior security interest in all the firm's assets, but the junior creditors claim that the bank's security interest is void because the leveraged buyout was a fraudulent conveyance.[23] A firm may face environmental liabilities of uncertain size. There is a patent dispute and the stakes are equal to the value of all the firm's other assets. The firm has many secured creditors, each with an interest in assets that are essential to keeping the firm intact as a going concern. The value of each secured creditor's claim relative

[22] See Bulow & Shoven (1978); White (1980).
[23] See Baird & Jackson (1985); Baird (1990).

to the other is unclear. For these and many other reasons, it may be hard to know who owns what.

The most straightforward type of firm in financial distress is the large, publicly traded firm with a simple capital structure that is in financial distress only. Much of the empirical work to date has focused on this kind of firm.[24] Even though these cases form only a small fraction of all the Chapter 11 cases brought, the total assets involved in these cases is large.[25] For such firms, Chapter 11 seems hard to justify. Markets would seem to work effectively here and problems of liquidity and private information seem unlikely.

The empirical evidence that has emerged over the last decade, however, suggests that Chapter 11's deficiencies in this context may have been exaggerated. The direct costs of bankruptcy for these firms seems relatively small. A Chapter 11 plan of reorganization is the equivalent of complete resolution of all the firm's outstanding legal disputes combined with 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, direct bankruptcy costs ranged between 0.9 and 7% of the book value of the assets before the filing of the bankruptcy petition. The average was 2.8%.[26] By contrast, the direct cash costs of initial public offerings for amounts greater than $10 million were about 10%.[27]

A restructuring in bankruptcy may be more akin to a private placement. Yet the costs of a private placement for even a large, well-known firm is not dramatically less, on a percentage basis, than the direct costs observed in large Chapter 11 reorganizations. 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

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[24]See LoPucki & Whitford (1993a); Weiss (1990). The paper in the law and economics of Chapter 11 that perhaps has garnered the most vitriolic attacks is also an empirical study of large firms. See Bradley & Rosenzweig (1992).

[25]See Flynn (1989).

[26]See Weiss (1990). White (1984) suggests that the direct costs of bankruptcy are comparable even for smaller firms.

[27]See Ritter (1987) at 272-73. A large part of the costs of the initial public offering, however, involve complying with the securities laws and these are not faced in Chapter 11. In addition, some cash outlays may be rents captured by investment bankers and not social costs.

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. Finally, even if the costs of Chapter 11 seemed high relative to the costs of auctions or the other alternatives to Chapter 11, one has to make sure that one is looking at only the Chapter 11 costs associated with changing the firms capital structure, not costs such as resolving disputes among the various players. These costs are incurred under all the different approaches.

One can argue that market-based alternatives to Chapter 11 eliminate the indirect costs of bankruptcy, particularly the costs that arise from a prolonged stay in Chapter 11.[28] The evidence here is less substantial, but still suggests that the costs are smaller than usually estimated for large firms with simple capital structures that are not in economic distress. First, the separation of ownership and control in firms of this type dramatically reduces the problem of managerial entrenchment. 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 six months after the reorganization is over. Indeed, the turnover rate of those hired to replace them is several times the rate of turnover for large, publicly traded firms generally.[29]

Determining the magnitude of bankruptcy costs, however, is hard, in large part because the indirect costs may be much larger than the direct costs.[30] We do see huge indirect costs in such large reorganizations as Eastern Airlines. The Eastern reorganization proved costly, however, because the firm was in economic as well as financial distress. The airline could not find its niche in the relevant market and might in fact have been worth more if it had been

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[28]White (1983).

[29]See LoPucki & Whitford (1993b) at 723-37. Gilson (1989) at 248 suggests a smaller, but still substantial turnover rate for the managers of distressed firms. To say this, however, is not to say that the managers are pursuing the interests of the firm as a whole. Although the creditors' committee and the postpetition lender may be able to exercise control indirectly, the shareholders nominally continue to control the managers. The managers, at least in some cases, openly embrace the idea that their duty lies with the shareholders. See LoPucki & Whitford (1993b) at 745.

[30]See White (1983).

broken up. Bankruptcy costs may be low for large firms that are in financial distress, but not economic distress. The best examples are firms that went through leveraged buyouts in the late 1980s and then could not meet their fixed obligations. In the case of Federated, the indirect costs of bankruptcy seem to have been less than 10% of the value of its assets.[31]

It is worth considering the conclusions that would follow if in fact Chapter 11 was an effective way of restructuring large firms with simple capital structures that were in only financial distress, but not economic distress. If this were indeed the case, the case for replacing Chapter 11 with more market-based alternatives becomes hard. The market-based alternatives are easiest to justify on theoretical grounds in this context, because objections based on complexity of the capital structure and the illiquidity of the assets are largely absent. If the empirical data suggests that they are not likely to work improvements in this context, one must explain why they are likely to do so in other contexts in which it is easier to find weaknesses in them.

We can get a sense of the problems that we shall have assessing alternatives to Chapter 11 in other types of cases by returning again to Bebchuk. His proposal becomes harder to implement when the firm has a complex capital structure, is closely held, or is in financial distress. A regime of options depends crucially upon a simple capital structure in which there is little doubt about what each investor is owed and the priority each enjoys. Assume that the only asset is a machine with custom dyes. One creditor has a security interest in

[31]See Kaplan (1989); Kaplan (1994a); Kaplan (1994b). Kaplan's work to date focuses only on Federated and one must be careful not to draw too many inferences from it. Kaplan is preparing a follow-up study that looks at other large firms that were financially distressed, but not economically distressed. One should also note that the Texaco bankruptcy may present a counterexample. Texaco's bankruptcy case ended much more quickly than anyone expected, and the rise in its stock price when the bankruptcy proceeding ended suggests that investors thought that an extend bankruptcy might be quite costly. See Mnookin & Wilson (1989); Cutler & Summers (1988). The rise, however, was so large (in the neighborhood of $2 billion) that some suspect that the price rise might have been because of an anticipated takeover that did not materialize.

the machine and the other in the dyes. Bebchuk's scheme does not tell us how to create options in this context.

When a firm is large, securities laws ensure that information about the firm is available to investors. Even if the investors are not large, a market will come into being for the options if the firm is large enough. Problems appear, however, when a firm is small. First, the lack of separation between equityholders and managers makes the existence of private information more likely. Second, those who hold the junior claims may not have the resources to exercise their options and a market for the options may not come into being.

Bebchuk's scheme is no harder to implement when the firm is in economic distress, but firms in economic distress need tending. The time needed to implement the option system—perhaps a number of months—may prove costly if decisions need to be made about the firm. Once the options have been exercised, we are left with a firm whose capital structure is likely suboptimal and whose economic distress is likely greater than it had been when Chapter 11 began.

For large, financially distressed firms with simple capital structures and little or no economic distress, Bebchuk's approach, like Aghion, Hart and Moore's may work well, but Chapter 11 may work here as well. Moreover, these cases may be less important than is commonly thought. To be sure, the size of the assets involved with publicly traded firms make large bankruptcies important, even if there are few of them. Many of the firms in Chapter 11, however, are in economic distress.[32] In addition, we may overestimate the number of firms with simply capital structures. A firm that has been through a leveraged buyout has a complex capital structure given that the claims of senior lenders may be void under fraudulent conveyance law. LTV faced billions in potential liability to workers and retirees, as well as environmental claims. These all need to be sorted out before we can know who owns what.

We may need to redirect our focus to other types of firms, our focus may change. The need to exploit market mechanisms may not

[32]LoPucki and Whitford's data suggest that even in the case of large publicly traded firms almost half needed not only a new capital structure, but also a dramatic change in the way they did business. By their count, only 22 of the firms in their sample of 43 emerged from Chapter 11 with their core business intact. LoPucki & Whitford (1993a).

loom as large. When there is much dispute about the rights of the various players, an ability to resolve disputes and offer clear title to the assets may be what matters the most. In the rest of this paper, I explore how Chapter 11 may be well-adapted to the challenges of gathering information and clearing title. The test for alternative regimes may lie not so much in the way in which they incorporate market mechanisms, but the way in which they handle these problems.

IV. DRAWING INFERENCES FROM THE FAILURE TO OPT OUT

The bedrock of United States corporate law is contractual. Each state has its own corporate law and large firms were more or less free to choose the state in which they are incorporated. The state of incorporation need not be the jurisdiction in which the headquarters lies nor need it do any business there. States compete for corporate charters and the revenues they bring. The effect of many different corporate laws gives prospective investors in firms a large menu from which to choose their rights and obligations. Because many states allow investors to depart from the various provisions of their corporate codes, the choice facing individual investors is larger still. This "race to the bottom" has had powerful beneficial effects on corporate law in the United States.[33]

If it makes sense to allow investors to choose among different rules governing the creation and life of an enterprise, one can argue that they should be able to choose the rules governing its reorganization as well.[34] Even if one is agnostic about whether Chapter 11 makes sense, there seems little reason not to let investors choose among different options and let them opt in or out of Chapter 11 as they see fit. Even the more modest solution of granting states the power to enact their own law of corporate reorganizations would seem a step in the right direction.[35]

This theoretical objection reenforces the objection that Chapter 11 relies unnecessarily on nonmarket valuation mechanisms. Nevertheless, these objections should not lead us to overlook an

[33]See Easterbrook and Fischel (1991).
[34]See Adler (1993); Rasmussen (1992).
[35]See Skeel (1994).

inference we may be able to draw from the failure of investors to opt out of Chapter 11. The net cost of Chapter 11 cannot exceed the costs investors must incur to opt out of Chapter 11 at the time they make their initial investments. If we can establish that the opt-out costs are low, we can infer from the decision of some investors to create firms that are eligible for Chapter 11 that its benefits are at least equal to its costs.

Blackletter law provides that a corporate debtor cannot waive its right to file a bankruptcy petition. Many have therefore assumed that "opting out" of bankruptcy is not possible. In fact, however, there are many ways to structure transactions that are economically equivalent to opting out. To start with the simplest case, a bankruptcy proceeding assumes the existence of debt and much entrepreneurial activity can take place without it. An absence of traditional debt is in fact commonplace. Nearly one-third of all closely held corporations have no institutional debt.[36]

Indeed, one of the hardest problems in corporate reorganizations—the one that arises when much of the value of the firm is in the firm-specific skills of the owner-manager—may arise infrequently in practice because such ventures are often not financed with debt. Many projects in high technology industries, such as computer or bioengineering, are financed through limited partnerships with venture capitalists that have no debt. When these firms fail, there are never going to be bankruptcy petitions.

There are, of course, benefits from including debt in a firm's capital structure.[37] Debt can serve as a bonding device and show to outsiders that the firm is doing well. A firm's ability to meet fixed obligations reveals information that is otherwise hard to convey. Assessing the costs and benefits of having debt, however, is no simple matter. In a reorganization, for example, the same private information that makes debt financing attractive before the fact makes debt less attractive when the firm is in reorganization.

Moreover, there are ways to ensure that investors never find themselves in bankruptcy court even when they are creditors. Recent years have seen the development of investment vehicles that are

[36]See Petersen and Rajan (1993) (28% of closely held corporations have no institutional debt).

[37]See Hart and Moore (1995).

"bankruptcy remote."[38] Let us assume that a group of investors wants to lend to a firm, but wants to ensure that if the firm encounters financial distress, the reorganization will not take place in Chapter 11, but rather will follow the procedures they set up in their debt contract. Instead of lending money directly to the firm, they can create an independent entity to which they give money and which in turn makes equity investments in the firm. The entity itself can be run by third parties. Even if it is run by the underlying firm, the entity's by-laws can provide that the entity can file a bankruptcy petition only if all its independent directors approve.

The lenders can each sign covenants not to file an involuntary petition against the entity. The loan agreement spells out exactly what happens in the event that the underlying firm does not have sufficient income to provide the entity with enough to meet the obligations under the loan. Those who operate the entity will have no stake in the underlying operating entity and hence no incentive to file a bankruptcy petition. The promise not to file an involuntary petition is probably enforceable.[39] Moreover, if the entity is set up as a trust, it is not even eligible to file a bankruptcy petition.[40] For good measure, the investors can ask the principals of the firm to sign a guarantee that obliges them to pay them in full in the event that either the trust or the firm enters bankruptcy. The underlying firm has no creditors, cannot become insolvent, and will never find itself in Chapter 11.

These "bankruptcy remote vehicles" are typically used for a specific purpose, such as securitization of accounts receivable, not to insulate the underlying firm from Chapter 11 completely, but it could in principle used more broadly. If these forms become widely used, we may infer that Chapter 11 does bring substantial costs. But if they do not, we should ask if there are special virtues to Chapter 11 that are not readily apparent.

At the outset, one must be careful about drawing too many inferences from the observation that investors today routinely make investments that are not bankruptcy remote. The costs of opting out may still be large enough to dissuade parties from doing it. Opting

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[38]See Graf (1995) at B16; Schwarcz (1993) at 16-27.
[39]Schorer and Rosenberg (1994).
[40]See In re Secured Equipment Trust, 38 F.3d 86 (2d Cir. 1994).

out of Chapter 11 requires a certain amount of lawyering and some of the methods need to be tested in the courts. The various techniques may not have had time to develop.[41]

Only in recent years has Chapter 11 proved itself a viable vehicle for managers. Hence, it is possible that opting out is only beginning to take place and that it will take some time before the costs of opting out are low enough to make it routine. The transaction costs of opting out typically involve creating multiple corporations, drafting particular by-laws and granting secured creditors a special set of rights. This must also be done in a way that navigates various problems under the tax laws, such as ensuring that transfers between the firm and the entity that shields the creditors do not trigger tax liability.

Moreover, until a large number of alternatives to Chapter 11 firmly establish themselves in the legal landscape, investors who opt out of Chapter 11 face legal risks and uncertainties that those who remain eligible do not. The creation of a bankruptcy remote vehicle and shepherding it through a reorganization creates a positive externality. If individual investors do not benefit enough from opting out of Chapter 11 could remain a standard that is not displaced, even though investors as a group would be better off if the default rule were something else.[42]

In addition, we have to remember that Chapter 11 possesses special rules that offer benefits to creditors as well as to managers. Chapter 11 provides firms with favorable tax treatment and sometimes an ability to evade government regulation and enjoy assets that they do not enjoy outside of bankruptcy. For this reason, Chapter 11 may work to the advantage of creditors as well as managers. It may be valuable to creditors simply because it undoes an efficiency created elsewhere. For example, the Trust Indenture Act

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[41]The incentive to opt out may have changed in 1978. Before the 1978 Bankruptcy Code, a corporate reorganization may have been sufficiently unattractive to managers that investors did not see a need to opt out. Under Chapter X, the managers had to turn control of the firm over to a trustee; under Chapter XI, junior creditors and shareholders lacked the ability to impose a plan of reorganization that would impair the rights of secured creditors.

[42]See Klausner (1995) at 766 n.25.

makes it impossible to restructure bonds outside of bankruptcy.[43] For all these reasons, investors may prefer Chapter 11 to the alternatives, even though its costs (including the costs it imposes upon third parties) exceed its benefits.

Investors may also decide against opting out because the costs of Chapter 11 may be small. As we have already noted, most cases in Chapter 11 have little to do with reorganizing firms. Many firms in Chapter 11 are worth reorganizing and have few assets. When a service firm, such as an ad agency, fails, there are no assets for creditors. For such firms, Chapter 11 (often subsequently converted into Chapter 7) may be as good a way of wrapping up the affairs of the business as any other. The costs of opting out in every case may exceed the costs of Chapter 11 in the minority of cases in which the firms can survive as going concerns, but need to be reorganized. Moreover, once investors understand the peculiarities of Chapter 11, they can structure their own investments to minimize the costs it imposes on them.[44]

For all these reasons, we may be able to infer that Chapter 11 is not terribly costly for creditors even if it brings no special benefits to the financially distressed firm. Nevertheless, it is important to identify what benefits these might be if they did exist. The next part of the paper shows how the equity receivership lowered transaction costs for the investors in railroads in the 1890s and its virtues may be ones that Chapter 11 possesses, but that have been long neglected.

V. EQUITY RECEIVERSHIPS AND THE ORIGINS OF CHAPTER 11

The United States law of corporate reorganizations took on its basic features in the 1890s. It was shaped in large part by a small number of bankers and lawyers who represented investors who had

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[43] See Roe (1987).

[44] To give a simple example, Chapter 11 recognizes the time value of a secured creditor's claim only if the secured creditor is oversecured. Hence, creditors have an incentive to ensure that their loans are smaller relative to the value of the collateral than they would be otherwise. In the end, creditors are no worse off and the firm as a whole suffers only from the loss of some of the benefit of secured credit. For a more extensive discussion of these and other issues, see Baird (1994).

put their capital in railroads that could not meet their debt obligations.[45] These bankers and lawyers used a particular legal mechanism, the equity receivership, to reorganize these railroads and the equity receivership is the direct ancestor of modern Chapter 11. These bankers and lawyers had strong incentives to further the interests of those they represented and they faced relatively low transaction costs working together. For this reason, we may be able to infer that the equity receivership, at least relative to the alternatives, was an efficient way to reorganize a large corporation.[46]

Railroads were the first giant privately financed corporations. At first, railroads could be financed by the farmers and merchants who lived near the proposed track and who would benefit from its construction. By 1860, however, private investment in railroads exceeded a billion dollars, and the entrepreneurs who built the roads had to seek capital from New York and the commercial centers of Europe. The great capitalists such as the Vanderbilts and the Forbeses and their associates invested in the railroads and then investment bankers such as J.P. Morgan, August Belmont, and Kidder Peabody found capital in the large commercial centers of Europe. These investment bankers sat on the boards of the various railroads and represented the interests of their European investors.[47] Because they counted on repeated dealings with these investors, they had the incentive to represent them well.

The period between 1865 and 1890 was one of enormous growth for the railroads. The period also saw the consolidation of different lines in haphazard and unpredictable ways. Over 75,000 miles of track was laid down in the 1880s and this was a time of increasing competition.[48] Moreover, there was at the same time

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[45] In 1893 alone, 27,000 miles of track in the United States went into receivership, more than existed in all of Britain at that time. Daggett (1908) at v; Chandler (1990) at 53. J.P. Morgan took the lead in reorganizing the Santa Fe, the Erie, and the Northern Pacific among others. Chandler (1977) at 171.

[46] Easterbrook goes much further than this. In Easterbrook (1990), he suggests that the political environment is one in which legislatures were not subject to special interest group pressures. He then draws the inference that Chapter 11 is likely to be efficient.

[47] Chandler (1977) at 146.

[48] For a discussion of the competition among railroads connecting Chicago with New York during this period, see Cronon (1991) at 81-93.

increasing government regulation, the most important of which was the Interstate Commerce Act of 1887. Competition among the different lines intensified, cartels came into existence and then fell apart. At the same time, the early 1890s brought on one of the United States's worst economic downturns. All these factors created an industry that by the mid-1890s was insolvent. Most of the railroads that had been built could not meet their fixed obligations. Over half of all the railroad tracks in the United States went through reorganization during this period, some more than once.

The railroads as a group possessed a number of characteristics that make them different from the firms that typically enter Chapter 11 today. First, these railroads were worth keeping intact as going concerns. Once a railroad is built, much of the cost is sunk and there are no alternative uses for the assets (the long strips of real property, the rails, the bridges, and the ties). It might make sense to sell off parts to other roads or to acquire lines from others, but the basic shape of the firm would remain unchanged. By contrast, firms that are self-evidently worth keeping intact as going concerns occupy only a small part of the modern Chapter 11 landscape.

Second, railroads had a capital structure that was quite different from what we see today. Most firms in Chapter 11 owe large amounts to their suppliers. This unsecured trade debt looms large in the capital structure and dealing with suppliers is one of the major problems in the typical Chapter 11. By contrast, railroads had little in the way of short-term debt. Suppliers of coal and the like were paid on an ongoing basis. Because these obligations were small relative to the amounts owed the investors and because their cooperation was important to keeping the railroad running, these suppliers were typically paid in full at the outset and they would play no role in the reorganization.[49]

Because the creditors of the 19th Century were largely institutional investors represented by a handful of bankers, the negotiation problem that a railroad confronted when it needed to be reorganized seems tractable. The capital structure of the railroads, however, was often Byzantine. Individual railroads were built in segments. Often

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[49]It was called the "six-months rule" because the practice was to pay debts for labor and supplies incurred in the ordinary course in the six months before the reorganization began. See Fosdick v. Schall 99 U.S. 235 (1878).

the costs of a segment were underestimated and there would be several layers of mortgages for each segment. When railroads merged, investors of each road would continue to hold security interests on discrete assets.

We did not have textbook capital structures with neatly layered hierarchical layers of ownership beginning with bonds, debentures, subordinated debentures, preferred equity, and common equity. Instead, there were often many different kinds of secured creditors. The problem in the reorganization was first to put a value on the rights of the different kinds of creditors. One would have to assess the value of a $1,000 bond secured by a third mortgage on a trunk line relative to a $1,000 bond secured by a first mortgage on a spur.

After one acquired a sense of the relative worth of each bond, the investors as a group needed to settle on a capital structure that was both simpler and one that took better account of the uncertainties in the income the road might generate. In 1889, the Atchison, Topeka, and Santa Fe had become a railroad that connected the American Southwest with the west coast, the Gulf coast, and Chicago. The system had 7,010 miles of track, almost half of what existed in Britain at the time. There were 41 classes of bonds and the outstanding indebtedness was $164 million. There were revenues of $28 million and operating expenses of $22 million.[50] The net earnings were insufficient to pay fixed interest costs and would likely remain so.[51]

Bringing about a successful reorganization was hard. The value of the railroad had to be estimated against a background of rapid technological and regulatory change. Moreover, the claim of the many different kinds of bondholders turned on how much their collateral contributes to the earnings of the railroad as a whole.

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[50]Daggett at 198-200.

[51] During the course of two reorganizations over the next six years, the classes of bonds were reduced to two, one of these paid interest only if earned, and the term of the bonds was extended. There was also an issue of preferred stock. See Daggett at 213. The new capital structure proved sound, and the railroad thrived in subsequent years. The principal on the last of the bonds issued in the second reorganization in 1895 will be paid in full this October. See Floyd Norris, "After 114 Years, It's Payday," New York Times at 17 (July 1, 1995).

There might have been ways to use the market to provide information on the first question, but not the second.

The investors confronted these problems in a legal landscape that offered no easy way to sort out their problems. A common law "composition" is a procedure that allows for creditors to give up a portion of their claim. The common law composition, however, provided no means to overcome the hold-out problem. A few dissenting creditors could prevent a reorganization from going forward and a unanimous consensus among all the investors was not possible. Common law compositions work best in small communities in which there are only a few investors and they are likely to have repeated dealings with each other and with the insolvent firm. (A supplier might be willing to compromise its claim if the alternative is to lose a customer going forward.)

In most jurisdictions outside the United States, the legislature enacts a scheme the provides creditors with a discrete set of rights against an insolvent firm. In the United States at the end of the 19th Century, however, no legislative scheme was in place. The United States has a legal tradition that is firmly wedded to the idea of dual sovereignty, even more so in the 19th Century than in the 20th. The state and federal government each had their own spheres of power. Powers enjoyed by one, even if unexercised, could not be employed by the other. In this case, the Constitution gives to Congress the power to enact "uniform laws on the subject of bankruptcies" and prohibits states from "impairing the obligations of contract."

During the period in which the great railroads were reorganized, states lacked the power to enact a law of corporate reorganization, at least not where some of the investors resided in another state as was always the case with large railroads. The Federal Constitution, as it was understood at the time, treated any nonconsensual modification of obligations owed to out-of-state creditors as an "impairment" of their contractual rights.[52] State law might (and in most cases did) set out a procedure that would allow creditors to levy upon personal property or foreclose on real property, but a state would lack the power to put in place a single procedure that would allow creditors to foreclose on all the assets of the railroad and still keep it running

[52]See Ogden v. Saunders, 25 U.S. (12 Wheat.) 213 (1827).

as a going concern. Among other things, a state court had no power to control the disposition of land located in another state.

Congress had the power to create such a procedure under the bankruptcy clause, but in the 1880s and early 1890s there was no federal bankruptcy law. Congress had enacted three earlier statutes, but they had all been controversial and they had each been repealed. Hence, the railroad investors had no ability to file for federal bankruptcy. Given the absence of other alternatives, the representatives of the investors took advantage of the equity receivership.

The equity receivership emerged in courts of equity. In these courts, a judge has the equitable power to appoint a receiver to take control of a litigant's assets. In recent years, federal courts have used the equity receivership to take control of a prison system that violated the Eighth Amendment rights of the inmates or a school system that ignored the 14th Amendment. In the typical case, the plaintiffs are creditors and the receiver comes into control of the property of the debtor. As these other examples suggest, the procedure is flexible. Lawyers for the creditors of troubled railroads, with the blessing of sympathetic judges, took advantage of the equity receivership.[53] As they used it over time, their practices became more fixed as judges set limits on how these receiverships could be used and how they could change the rights of the various affected parties. What emerged in the end were the basic features of Chapter 11.

The following is a stylized example of an equity receivership.[54] A railroad has 100,000 shares of stock outstanding. It owes $150 million, $50 million to three different groups of bondholders. The first loan of $50 million was used to build the main line, the second to build the terminal, and the third to build a line connecting the terminal to a port. The remaining creditors are suppliers and a few others whose loans are unsecured. The railroad cannot meet payments on the $150 million of debt. Indeed, the railroad is worth less than the $100 million. The railroad defaults on its fixed obliga-

[53]For a personal account of what the lawyers did in the equity receiverships, see Robert Swaine, The Cravath Firm and Its Predecessors (1948). For a more general account of the work of lawyers, investment bankers and other professionals, see Robert W. Gordon, Legal Thought and Legal Practice in the Age of American Enterprise, 1870–1920, in Gerald Geison, Professions and Professional Ideologies in America (1983).

[54]The following is drawn from Baird (1993).

tions and the investment bankers representing the three groups of bondholders realize that the time has come to restructure the firm.

The investors call upon their lawyers and their investment bankers. The lawyers persuade a general creditor to ask a federal court to appoint a receiver for the railroad. The receiver the court appoints is often the group of manager-shareholders that has been running the railroad. The receiver pays off all the suppliers in full and keeps the railroad running. In the meantime, lawyers and the investment bankers form four committees, representing the three classes of bondholders and the equityholders. Each bondholders' committee persuades most of the bondholders to deposit their bonds with it and give it the power to assert all the rights of the bondholders in the reorganization. Let us assume that, in our case, 90 percent of the bondholders in each class give their bonds to their committee.

The four committees then meet and create a new committee, the reorganization committee, on which members of each of the other committees sit and which is empowered to act on behalf of the other committees. The reorganization committee now controls 90 percent of all outstanding securities. It then proceeds to form a plan of reorganization. In this case, the reorganization committee must decide first how much each group of bondholders should receive and then what a new capital structure should look like.

In our case, each group might insist on an equal share, given that each invested $50 million. On the other hand, some of the investments might have been less successful. For example, if the line connecting the terminal to the port had not brought much business, the representatives of the two other committees might be able to insist on a larger share. In the typical case, the plan might reduce the rate of interest, make interest payments contingent upon income, convert debt to preferred stock, reduce the amount of principal, or extend the term of the loan.[55]

To keep things simple, let us assume that this plan provided that each group of bondholders reduce their claims by 40% and for the new bonds to be secured by all three assets. Each $1,000 bond secured by one of the three assets will be exchanged for a $600 bond

[55]In the case of the Atchison, Topeka and Santa Fe, 30-year 6% bonds originally due in 1911 became 100-year 4% bonds due in 1995.

secured by all of the railroad's assets. The shareholders who turned over their shares to the committee are given the option to exchange an old share of stock and $15 for a new share of stock. Through their representatives on the reorganization committee, the participating creditors and shareholders consent to this plan.

The reorganization committee then borrows $15 million from a bank on a short-term basis. At this point, the receiver conducts a foreclosure sale in which the assets of the railroad are sold to the highest bidder. Although the foreclosure sale is nominally open to anyone, in practice the reorganization committee usually turns out to be the only bidder. It bids $15 million, $5 million for the main line, the terminal, and the connecting line respectively. The receiver takes the $15 million and distributes it to the bondholders. Because the reorganization committee itself owns 90 percent of the bonds, the receiver gives back to the reorganization committee $13.5 million of the $15 million the committee paid to buy the railroad. The receiver pays the other $1.5 million to the nonparticipating bondholders who did not give their bonds to the reorganization committee.[56] The shareholders get none of the proceeds because the sale price was not enough to pay the bondholders, who enjoyed a higher priority, in full.

After the foreclosure sale, the old corporation is a hollow shell and the old shareholders dissolve it under state law. Because the legal entity that was the railroad now no longer exists, all claims against it are worthless. Hence any shareholders who did not turn over their rights to the relevant committee are out of luck, as are any general creditors.

At this point, the reorganization committee has the assets of the railroad and the $13.5 million it received from the receiver. The committee now forms a new corporation and transfers all the assets of the railroad to it. The new corporation creates $90 million in bonds and gives them to the old participating bondholders as

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[56]Recall that ten percent of the bondholders did not participate. Hence, each of the bondholders who did not participate receives only 10 cents on the dollar, much less than they would have received if they had participated in the reorganization in which they would have received 60 cents on the dollar. The device of the nominally open foreclosure sale in the equity receivership is what allowed the freezing out nonparticipating bondholders and hence largely eliminated the holdout problem of the common law composition.

promised in the reorganization plan. All the stock in the new firm is given to the old shareholders when they come up with the $1.5 million in cash they promised in the reorganization plan. With this $1.5 million and the $13.5 million the receiver gave it, the committee repays the $15 million bank loan. The reorganization committee now goes out of existence.

If we focus entirely on legal forms, we see a new corporation with a new set of ownership claims against it. In substance, however, the story is quite different. If one collapses the various steps in this elaborate dance, most of the bondholders and shareholders have simply exchanged their old claims against the firm for new ones that take better account of the condition in which the railroad finds itself. We have exactly the same railroad with the same managers and the same investors, but the ownership rights of the investors have been adjusted so that they are in line with the revenue that the railroad actually earns.

The evolution of the equity receivership is similar in form to evolution we see elsewhere in commercial law. The clarity of the legal rules matters as much as their content. Moreover, the rights the legal regime grants need to bind not only the parties, but third parties as well. For this reason, it was entirely predictable that investors would turn to a vehicle such as the equity receivership to solve the problems they confronted. To ensure that the reorganization provided ownership rights that everyone would recognize, they needed some legal device that could give clear title.[57]

The strong tradition of dual sovereignty, the contracts clause and Congress's failure to enact a bankruptcy law created an environment in which rational investors would turn to the equity receivership as a way to reorganize an insolvent firm. Rational investors of 19th Century railroads would want an equity receivership if other alternatives existed. Nevertheless, it is worth noting that the equity receivership had some virtues that made it particularly well suited to sorting out the rights of investors in 19th Century railroads. First, the committee structure and the process of bargaining among the

[57]One of the great issues in the law of equity receiverships concerned the hoops through which one had to jump to ensure that all the creditors of the old railroad were bound. See Northern Pacific Railway Co. v. Boyd, 228 U.S. 482 (1913).

different committees was ideal for an insolvent firm that had a complex capital structures. Market-based mechanisms for establishing the rights of different investors are hard to devise when the ownership rights are not hierarchical.

In the case of the railroads, the operations of the firm and the problems with the capital structure could be cleanly separated from one another. These were the first firms in which we see a clean separation between the providers of capital and those who ran the day-to-day operations. A relatively drawn-out legal process that follows an elaborate set of negotiations is less costly if the problems associated with fixing the firm's capital structure can be readily separated from the operational issues.

Moreover, these firms were large and capital markets were far less developed than they are today. The lack of reliance on market-mechanisms to determine the value of the firm is less troubling if there are doubts about the ability of a sale to attract bidders. In any event, the equity receivership had an actual market sale that was, in theory, open to outsiders. It is a feature that contrasts with Chapter 11 in which there is no mandate that requires bids from outsiders to be considered.[58]

The problems that the great railroads faced in the late 19th Century may allow us to speculate why the law of the United States evolved towards Chapter 11 and the law of other jurisdictions did not. Laws that work relatively well may be hard to displace, even if a legislature might adopt a radically different regime if writing on a blank slate. Other jurisdictions may lack a legal regime resembling Chapter 11 because they did not have the need for something like the equity receivership at an earlier time. These other jurisdictions may not have had the lacuna in its legal system such as the one in United States law because of dual sovereignty. A coherent set of laws might have already addressed the rights of creditors and other investors.

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[58]There were, however, no outside bidders in the railroad equity receiverships. The committees could bid their claims and outsiders may have lacked both the capital and the information needed to bid against them. Similarly, it is possible to make too much of the absence of market mechanisms under current law. Able judges today would rarely ignore a credible outside bid and march forward with a forced sale over the objections of senior creditors.

Second, other jurisdictions did not need as much capital and may not have relied so heavily or private capital for the construction of railroads. When they did, the investors may have been less distant and less diffuse. Third, the railroads were generally smaller, and, because the railroads were built later, their capital structures may have been simpler. Complex capital structures are most likely to exist in an era of massive regulatory and technological change. Railroads in other jurisdictions may have learned from the United States experience. For all these reasons, there was no need for something akin to the equity receivership and hence nothing out of which a regime analogous to Chapter 11 might evolve.

The development of the law between the age of the great railroad reorganizations in the late 19th Century and the enactment of the 1978 Bankruptcy Code may have several additional lessons for us. The Chandler Act and other legislation in the 1930s introduced and codified features that came into being after the equity receivership began to be applied to many other kinds of firms. Two routes became available, Chapter XI and Chapter X respectively. Each, however, was more limited than the equity receivership had been. Under Chapter XI, the managers remained in control, but they lacked the ability to restructure secured debt. Under Chapter X, secured debt could be restructured, but the management of the firm came into the hands of a trustee. (A receiver displaced the managers in an equity receivership in principle, but in practice the receiver was the existing management or closely allied with it.)

These changes may have came about because they were thought necessary to protect investors. They were widely dispersed, and lawmakers thought that these investors had little ability to monitor the directors and managers who were also often large shareholders.[59] During the time of the great railroad reorganizations, these fears were likely misplaced. The need of the insiders to return to the same sources of capital in the future should have done much to ensure

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[59]See Douglas (1937). This multi-volume work was done under William O. Douglas's auspices while he was a Commissioner of the Securities and Exchange Commission. They reflect the thinking of New Deal lawyers active in the creation of the Chandler Act and the other bankruptcy legislation of the 1930s. While serving on the Supreme Court, Douglas made important contributions to the absolute priority rule in such opinions as Case v. Los Angeles Lumber Products, 308 U.S. 106 (1939).

that they were loyal fiduciaries. The survival after a century of the law firm (Cravath) and the bank (J.P. Morgan) most involved in these cases further suggests that they worked with the long term in view.

By the 1930s, however, the same forces might not have worked as effectively. In the case of closely held firms in which the managers are also the holders of the equity, the problems Douglas addressed are considerably magnified. These problems have also been closely studied in recent years.[60] Smaller firms with hierarchical capital structures may incur large agency costs.[61] Loan covenants can minimize some of these problems, such as the danger of the manager-owners issuing debt senior to that of existing creditors.[62] Fraudulent conveyance law controls the manager-owners' temptation to remove assets from corporate solution. The problems of over- and underinvestment, however, are less tractable.[63] Manager-owners may favor risky projects and ignore safe ones. An owner-manager of a firm that has debt of $100 and assets of $10 has no incentive to make an investment that is certain to bring a return of $20, but does have the incentive to invest in a project will return more than $100, even if the risks do not justify it.

We must also take account of the effects of bankruptcy even when the firm is not financially distressed. A reorganization procedure that gives managers a soft landing may reduce their incentives to maximize the value of the firm before the fact, but, if they are risk averse, a soft landing may be desirable nevertheless.[64] There are additional complications as well. Before the firm is in financial distress, manager-owners may have the incentive to overinvest in firm-specific capital. By doing this, the manager-owners can entrench themselves, but it may also reduce their incentives to make themselves indispensable.[65]

These agency problems, however, are easy to overstate for large firms. Douglas, like Berle and Means, may not have understood the

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[60] See Gertner & Scharfstein (1991); Rasmussen (1994).

[61] See Jensen & Meckling (1976); Meyers (1977).

[62] See Smith & Warner (1979).

[63] See Rose-Ackerman (1991); White (1993).

[64] See White (1993). A general discussion of this problem can be found in Hölmstrom (1982).

[65] See Bebchuk & Picker (1993).

market for corporate control and other mechanisms that kept managers and other insiders in line even when there was a separation of ownership and control.[66] In any event, the rule changes that Douglas and others spear-headed are likely responsible for the decline in the importance of corporate reorganizations for large firms until the 1978 Bankruptcy Code, which expanded the role that managers had in a reorganization. A procedure, whether good or bad, is never going to be used unless someone has an incentive to invoke it. If a reorganization regime dislodges managers, we should not be surprised if they do not use it. If managers will not begin the proceeding, incentives must exist so that someone else does.[67]

VI. CHAPTER 11 THROUGH THE LENS OF THE EQUITY RECEIVERSHIP

The equity receivership was a sensible way for investors in a 19th Century insolvent railway to sort out their rights, given the legal and economic conditions in which they found themselves and the other choices that were available to them. The problems of the 19th Century railroads, however, seem radically different from the problems insolvent firms face today. The economic and regulatory environments are not the same. The bizarre capital structure of multiple kinds of secured debt no longer exists. Capital markets are much more developed. Finally, few firms have assets whose value is so linked to the continuation of the firm as a going concern.

Notwithstanding these qualifications, there may be firms that share the same essential characteristics as the insolvent railroads of the 19th Century. Many firms have complex capital structures. The neat pattern of layered debt and equity that we see in finance texts is not pervasive. For a firm of any size, there is no simple way to gain a blanket priority over all the assets. A separate mortgage must be recorded for every piece of real property. A single security agreement can embrace all of a debtor's personal property, but a creditor enjoys a priority with respect to them only if proper public filings are made. In most cases, there needs to be one (and sometimes multiple

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[66]Douglas does explicitly rely on Berle & Means (1933) in his study of equity receiverships. See, e.g., Douglas (1937) at Part I, p. 5 n.4.

[67]See Baird (1991); White (1993).

filings) in each jurisdiction in which property is located. Sometimes other creditors need to be notified. A constant vigilance may need to be kept for tax liens. Special techniques are needed to ensure priority over cash proceeds and securities. In addition, creditors are likely to find holes in their priority positions with respect to property (including inventory or receivables) that the firm receives while it is insolvent.[68] It is not uncommon for reorganizations to focus much of their attention on the resolution of these issues.

The traditional balance sheet no longer identifies many of the important creditors in a bankruptcy case. High technology firms have intellectual property disputes with their principal competitor. The dispute might take several years to litigate, but the expected liability may approach the value of the firm. Putting a value on the rights of the competitor is not easy.[69] Many firms have long-term leases of real property. The lessor may have invested substantial amounts in customizing the building for the debtor and obligations under the lease may be tied to the revenues of the firm. Understanding the relative rights and obligations of the parties is hard.[70] The lease is both an asset and a liability for the debtor.

A firm may have a long-term relationship with a supplier or a buyer. These relationships themselves can be both assets and liabilities. Even in the absence of a contract between the two firms, the relationship can be one that looms large in any reorganization of a firm. If a firm has invested large resources in developing a custom part for one of its buyers, the success of any reorganization may turn on what happens to this relationship, especially if the other firm has patented the part or if the manufacturing process is a trade secret. This asset is similarly one that is hard to value.

Many manufacturing firms face potential environmental liabilities under state and federal laws. Even a firm that put only a small amount of its waste product at a dump site in full compliance

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[68]These problems are the domain of fraudulent conveyance law and the law of voidable preferences. See 11 U.S.C. §§547 & 548.

[69]For a case that gives some sense of the problems of dealing with creditors who have contingent claims, see Bittner v. Borne Chemical Co., 691 F.2d 134 (3d Cir. 1982).

[70]Section 365 of the Bankruptcy Code tells us what happens to leases in a reorganization. It is both one of the most complicated and one of the least successful parts of the Bankruptcy Code.

with all applicable laws may find itself facing joint and several liability for the clean-up costs that again equals or exceeds its net worth. Firms may face tax liabilities that must be litigated. Regulatory liability is increasingly common and often spreads across corporate entities. A parent firm may be responsible for obligations of its subsidiary, even though garden-variety creditors would not be able to pierce the corporate veil.

A complete picture of the capital structure of a firm often requires capturing accurately relationships that are more complicated than that of identifying creditors along such straightforward dimensions as how much they are owed and what priority they enjoy. In addition, the more complicated a firm's capital structure, the harder it will be to write a completely specified contract. Ideally, the contract that the investors write sets out the rights of all the players under all possible states of the firm in a way that maximizes the value of the firm's assets.

Most investment contracts fail to set out the rights of the parties in a way that anticipates all the ways in which things can go wrong. Moreover, the loan documents may not even provide for the rights and obligations of the parties in many of the situations that arise when the firm fails. The reorganization is necessary because the world has changed in a way that is unanticipated. The problem of corporate reorganizations looms largest in industries in which there is rapid technological and legal change. It is precisely in these cases where contractual solutions before the fact are least likely to be adequate.

Chapter 11 is easiest to justify and is most interesting where the problems that the investors face at the time of the reorganization is one that they could not have identified at the time of their original investments. Many of the industries that went through reorganization over the last hundred years have been industries in which there was rapid economic, technological and regulatory change.[71] The great railroads were created before anyone had experience with how giant firms should be capitalized. They matured just at the time of one of the country's great economic depressions and at a time when they were increasingly becoming subject to regulation. The utility

[71]The shopping center reorganizations of the late 1980s are a conspicuous exception to this general rule.

reorganizations of the 1930s, as well as the airline reorganizations of the 1980s that come in the wake of deregulation and the invention of the hub-and-spoke system tell a similar story.

Many firms need a forum such as Chapter 11 if only to ensure that there is some mechanism that allows there to be a reorganization that can give clean title to the investors on the scene after the reorganization is over. Prepackaged bankruptcies have become commonplace in recent years in large part because the bankruptcy court can bless the reorganization and give all the new participants clear title. This matters not only in complicated regulatory environments, but also with respect to secured creditors who in theory possess a priority interest in all the debtor's assets, but can assert these rights outside of bankruptcy only by invoking foreclosure procedures in all the jurisdictions in which the firm has real property.

The title-clearing function of Chapter 11 is one of its most important. Because of the long tradition of dual sovereignty in the United States, the existence of such a forum continues to matter. Even if a market sale makes sense, a market sale is going to bring maximum value to the owners of the firm only if the person conducting the sale can warrant good title. A bankruptcy judge under Chapter 11 has the power to do this in a way that few others do.

The first phase of the equity receivership often was spent reviewing the books of the firms and finding out what the earnings of the railroad were.[72] Chapter 11, like the equity receivership, allows creditors to gather information in a way that they could not otherwise. First, the creditors as a group can have an expert appointed to act on their behalf. Second, the court has the power to sanction anyone who falsifies information or simply fails to turn it over. Just as granting clear title is a function Chapter 11 serves that is hard to replicate contractually, so too is this information gathering role. We do, of course, see legal regimes in which firms are required to gather and turn over information (the take-over market is the

[72]To return to our basic case, the dynamics of the second reorganization of the Atchison, Topeka, and Santa Fe discussed earlier changed dramatically when the investors discovered that the railroad had been offering secret rebates to their shippers and failed to report these rebates on the balance sheet. See Daggett at 208-10.

most conspicuous), but even here the mechanism works effectively because of judicial oversight.

Finally, Chapter 11 allows for ways to overcome the collective action problems that might otherwise exist with diverse creditors.[73] To be sure, investors can create mechanisms among themselves that largely eliminate these problems among ordinary private consensual creditors,[74] but in a regulatory state, those with rights against the firm will include many who are not ordinary investors, but may be government agencies. Those with the power to bind an agency may be hard to bring to the bargaining table in the absence of a legal forum that mandates it. The court mechanism also gives ordinary creditors a way to bring different government agencies to the bargaining table.

Understanding the potential virtues of Chapter 11 might best be seen by examining the situation in which investors in the health care industry will soon find themselves in the United States.[75] The next decade will be a time of massive regulatory and technological change. Procedures that once required weeks of hospitalization will become out-patient procedures. Insurance companies are becoming owners of health maintenance organizations. Large hospitals are entering into alliances with physician groups and other health care providers.

The capital demands of the industry are enormous. Hospitals must build new facilities to accommodate the expanding outpatient practice. These buildings will have no other use, nor will the multi-million dollar pieces of equipment that will be installed in them. The structure of the industry is rapidly changing.

As in the case of the railroads in the 1890s, there are many mergers, and many firms are forming alliances and relationships with one another. Until we reach a new equilibrium, it will be often hard to understand the capital structure of each firm. It is not clear in many cases who owns what or which firm enjoys favorable

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[73]The collective action problem that diverse creditors face when a firm encounters financial distress has long been one of the central themes of the law and economics of bankruptcy. See, e.g., Bulow & Shoven (1979); Jackson (1982). For an empirical study of the bargaining dynamics between bondholders and banks, see Asquith, Gertner & Scharfstein (1994).

[74]See Picker (1992).

[75]Warren & Sage (1994).

contracts or has the right to the services of particular groups of doctors and surgeons. If different groups pool resources to acquire multi-million dollar machines for magnetic image resonance and the like.

How the rights of investors in these different health-care firms will be unraveled when one or more becomes insolvent remains unknown. This arena does not seem to be one in which investors can anticipate all the problems they are likely to encounter and provide for them in their loan contracts. Some heath-care firms will fail, and when they fail, investors will need a forum in which relevant information can be gathered. They will need a forum in which ownership of the various assets can be fixed. The forum will also be one that can force all the players, including recalcitrant government bureaucrats to sit down and negotiate with each other.

The infra-structure of Chapter 11 will handle these problems well, in large measure because they are the same problems that railroads faced in the late 19th Century. A bankruptcy judge can oversee a reorganization, ensure the relevant information is gathered, confront the regulatory complexities, bring all the players to the bargaining table, sort out their rights, and give the new owners clear title to a new entity whose capital structure is more suited to the needs of the industry, whatever they prove to be.

VII. UNBUNDLING CHAPTER 11

Chapter 11 may be able to sort out the problems of firms with complex capital structures. When such firms find themselves in the midst of a economic downturn confronting rapid regulatory and technological change, contractual alternatives may not work well. The question remains, however, whether Chapter 11 possesses any special virtues to handle these problems that one could not also find in a more traditional legal regime in which a court oversees a liquidation of the firm. These courts may also be able to perform the same functions. A regime based on the equity receivership can preserve going concerns because it effectively solves collective action problems, facilitates the gathering of information, and ensures clear title, but other legal regimes may be able to do this as well.

To say that investors opt for the equity receivership and modern Chapter 11 is only to say that they are better than the other alternatives that United States law provides. Other legal regimes might be as good or even better. More to the point, the differences between the essential characteristics of Chapter 11 and liquidation regimes are much smaller than typically imagined.[76] Once the rhetoric is put to one side and the idiocies of modern Chapter 11 are corrected, the differences between a legal regime in which a judge oversees a liquidation and a judge oversees a Chapter 11-style reorganization may turn more on the ability of the judge than anything else.

Although Chapter 11 has a hypothetical sale as the norm, a Chapter 11 judge has the power to oversee a sale of the assets as a going concern if one of the parties requests it. A judge who squarely focuses on sorting out the rights of the investors and choosing the course that is most likely to promote their interests will not behave much differently from a judge overseeing a liquidation. Each should be willing to sell the firm to third parties or existing investors in a way that is in the best interests of all concerned.

The judge in Chapter 11, however, is invested with enormous discretion. Moreover, the federal court system allows those who initiate the Chapter 11 (typically the managers of the firm and the firm's reorganization lawyers) to pick the forum in which the cases will be heard. The Eastern Airlines bankruptcy bears the case name "In re Ionosphere Clubs, Inc." Ionosphere Clubs was a subsidiary of Eastern that ran its departure lounges. Because Ionosphere was a New York corporation, it was possible to file its Chapter 11 petition in the Southern District of New York. Once it filed, all the related corporations, including the airline itself, could join it. For similar reasons, the LTV bankruptcy is called "In re Chateaugay Corp." Many important reorganizations have fallen into the laps of judges who have reputations for being generous in giving managers a second chance and in awarding generous fees to their lawyers and advisors.[77] By contrast, the equity receiverships tended to be initiated and controlled by those who represented the various bondholders, the residual owners of the firm.

Corporate law in the United States has been successful because of competition among different jurisdictions. The biggest challenge facing any legal system that emulates Chapter 11 may not be so

[76]See LoPucki and Triantis (1993).
[77]See LoPucki and Whitford (1991).

much to create the mechanism that ensures that the judge acts in a way that vindicates the wishes of the investors. Once the law of corporate reorganization invests judges with extraordinary discretion, one of the large challenges is creating a system in which the judges are able and that the party that begins the proceeding has an incentive to pick the judge who is most likely to look after the interests of the investors as a whole.

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