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CHAPTER 11'S EXPANDING UNIVERSE

*Douglas G. Baird**

In their 1990 pathbreaking study in the *University of Pennsylvania Law Review*,[1] Lynn LoPucki and Bill Whitford were the first to provide a clear picture of large corporate reorganizations. They encountered a universe with a population of forty-three cases. Today it numbers more than a thousand, and it has evolved as it has expanded. One can take stock of how things have changed using the Bankruptcy Research Database (BRD), the tool that grew out of LoPucki and Whitford's study. The BRD is the first source to which everyone turns to understand large bankruptcies.[2] With hundreds of data fields for every case, it provides a window into the world of corporate reorganizations. It offers a synoptic view of how large reorganizations work and how they have changed over time.

Long before others noticed them, LoPucki and Whitford flagged the issues that dominate reorganization debates today. They showed that, even in the 1980s, asset sales were "already a common feature of Chapter 11 cases."[3] They highlighted the practice of those filing petitions choosing a forum that suits them.[4] Recidivism is another problem they identified. Prepackaged bankruptcy is another phenomenon that they isolated. With the help of the BRD, it is possible to trace the evolution of what have become the most salient features of modern Chapter 11.

Observing change, however, is only a first step. One of the central lessons of Bill Whitford's work, both in his collaboration with LoPucki and elsewhere, is the one the Wisconsin School imparts more generally. Naked statistics alone are not enough to take the pulse of legal phenomena. They provide rigor and structure, but interviews and close examination of the facts are essential to understanding what is going on. This is especially the case in bankruptcy. Then, as now, it is a closed universe in which a relatively small handful of lawyers

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* Harry A. Bigelow Distinguished Service Professor, University of Chicago. I am grateful to Lynn LoPucki for his help. Daniel Marcin assisted me on the empirical work. The John M. Olin Fund provided research support.

1. Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990).

2. I count myself among the many to have benefited enormously from the BRD. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003). My students have used it as well. *See, e.g.*, Ramanadh V. Chivukula, Critical Vendors and Bankruptcy (Mar. 2013) (unpublished Ph.D. dissertation, University of Chicago Booth School of Business).

3. *See* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 600 (1993).

4. Thirty percent of their cases were filed distant from corporate headquarters. Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 29.

develop practices largely invisible to outsiders.[5] This is a world in which law and norms evolve together. This Essay sketches out some of the lines of inquiry that the BRD invites, but does not completely answer.

Although many bankruptcy debates have focused on the question of priority, it has become increasingly clear in recent years that the more relevant question for bankruptcy reform centers around control rights. It is the battle for control rather than competing theories of priority that tells the story of change in large reorganization practice over the last two decades. A number of academics have begun to talk about the importance of control in the last decade or so,[6] but LoPucki and Whitford recognized the importance of the issue long before anyone else. Their examination of large cases showed that debates about absolute priority are a "tempest in a teapot."[7] Deviations from absolute priority were not the main event. More important is the way the law and the norms of bankruptcy and corporate law affect those who have their hands on the levers of corporate governance.

I. TRENDS IN THE BANKRUPTCY RESEARCH DATABASE

From the filing of Penn-Dixie to the recent filing of Energy Futures Holding, the BRD now includes more than one thousand cases.[8] To observe changes in large bankruptcy cases over time in the BRD, I group them into seven cohorts of five years each. LoPucki and Whitford's initial study overlaps with the first two cohorts.[9] This breakdown of large bankruptcy cases shows potential patterns and identifies the issues worth pursuing further.

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5. LoPucki and Whitford found the practice of bankruptcy highly concentrated. Only a handful of small firms handled large corporate reorganizations. Levin & Weintraub and Stutman, Triester & Glatt represent almost a third of all the firms in their initial sample. Large firms such as Weil, Gotshal & Manges and Sidley & Austin also handled multiple cases in their sample, but though these firms were large, the bankruptcy practice within them consisted of small teams. The reorganization lawyers at Weil, Gotshal had worked together at Seligson & Morris. *See* Michael Y. Park, *A Minor Deity in the Bankruptcy Arena*, N.Y. METRO AREA SUPER LAWYERS, Sept. 2009, *available at* http://www.superlawyers.com/new-york-metro/article/A-Minor-Deity-in-the-Bankruptcy-Arena/ddf25722-fb17-4ad5-9619-7f1aea9bb5e5.html. Similarly, Sidley & Austin's bankruptcy practice was centered around lawyers who worked together at Shutan & Trost, another small boutique bankruptcy shop. Large firms have largely displaced small ones, but the number of lawyers around whom the reorganization practice is built remains quite small and stable. Harvey Miller, for example, was at the center of Weil's reorganization practice from the early 1970s until well into this decade.

6. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004).

7. *See* LoPucki & Whitford, *supra* note 1, at 126.

8. I use the December 2014 version of BRD in this Essay.

9. LoPucki and Whitford included in their sample the large cases that had concluded by March 1988. This does not include all the cases in the first cohort as some were still ongoing, and it excludes many in the second cohort. In addition, three of the forty-three cases were later dropped from the BRD as its protocols were refined. When I provide summary statistics for LoPucki and Whitford (as opposed to the five-year cohorts), I use only these forty cases. Dropping these three cases makes the comparisons consistent with other cases in the BRD. In addition, it allows me to use data in the BRD

One must exercise caution and not draw conclusions too quickly. Each of the seven cohorts is different. For example, more than 20% of the cases involved retail businesses in the 1990s, but fewer than 10% of those filed from 1985 to 1989 and from 2005 to 2009 were retail businesses. Similarly, many of the large reorganizations between 2000 and 2004 are casualties from the collapse of the dot-com bubble. The distribution of this cohort's Standard Industrial Classification (SIC) codes reflect this.[10] To bring what is happening into sharper focus, it is necessary to hold these and other features constant and treat summary statistics with skepticism. Nevertheless, patterns quickly emerge that invite further inquiry.

The phenomenon of firms emerging from bankruptcy only to refile again has been remarkably stable over time, with the exception of the second half of the 1990s. The number of firms that enter bankruptcy a second time within five years of emerging from bankruptcy ranged between 4% and 15% over the last three and a half decades in every cohort but one. During the late 1990s it jumped to almost 20%.

There are no obvious changes that explain why recidivism would rise so much during this one period. It was 12% in the cohort before and 9% in the cohort after. The total number of cases filed did not change. The relative shares of retailing, manufacturing, and transportation firms remained unchanged from the first half of the 1990s until the second half. The total number of prepackaged and prenegotiated plans was higher during this period than at any other time, but this change alone does not explain the difference.[11]

One might cut the data differently.[12] The number of refilings might rise if courts were more likely to confirm plans in the first place instead of liquidating firms. If more of the weaker cases are confirmed, then the surviving firms might be less healthy. The percentage of cases that refile should go up. To account for this effect, one might look at the total number of refilings relative to the total number of cases filed (instead of the number of refilings relative to the number of cases that emerge). By this measure, the contrast is less striking, but the late 1990s still appears very much an outlier.

Here is a puzzle that bears scrutiny. It is possible that the spike in the late 1990s is both benign and uninteresting, but closer study might shed additional light on the problem of jurisdictional competition. By LoPucki's account, this was the era in which other jurisdictions began to compete with Delaware and the

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for these cases that were not reported in their initial study. Including these three additional cases, however, would not affect the observations here in any way worth noting.

10. To be concrete, 26% of the large cases were in the SIC industry group containing transportation, electric, and communication services. In most cohorts, the percentage was 12% or less. It reached 18% and 16% in two other cohorts.

11. The number of cases that were either prepackaged or prenegotiated was 34% during this period. In the cohort before and after, it was 26% and 28% respectively.

12. *See* Lynn LoPucki, *Changes in Chapter 11 Success Levels Since 1980*, 87 TEMP. L. REV. 989, 1008 fig.6 (2015) (examining the five-year refilling rates from 1984 to 2008).

Southern District of New York.[13] We might have found ourselves in a period of disequilibrium. Judges during this period might have been willing to approve plans that were too risky, but they learned their lesson and the rate of refilings returned to its natural level. This hypothesis may be right or wrong, but it is worth further study.

Apart from this recidivism puzzle, what is most manifest from even the most cursory review of the different cohorts is a massive transformation that took place in the 1990s. Chapter 11s took much less time. The median Chapter 11 lasted about 900 days during the 1980s. But beginning in the 1990s until the present, the median ranged between 460 and 605 days.[14] Sales began to rise in the mid-1990s. Only 4% to 7% of the cases filed before 1995 are going-concern sales under § 363 of the Bankruptcy Code. They rose to nearly 20% in the five years before 2000, and have hovered around 25% since then.

Prepackaged bankruptcies are contemplated in the Bankruptcy Code itself, but there were none in the first five years under the Bankruptcy Code and only one in the next five years. Between 1990 and 1994, however, 19% of all cases filed were prepackaged. During the next five years, prenegotiated plans became more common and, to some extent, appear to displace prepacked bankruptcies. Prepackaged bankruptcies fell to 13% of all cases; prenegotiated plans increased from 7% of all cases filed to a little more than 20%. Between 1990 and 2009, prepackaged and prearranged bankruptcy constituted between 26% and 34% of all cases filed. Since 2010, 44% were prepackaged or prearranged. One cannot tell yet from the data alone whether this is a onetime increase (perhaps because of the financial crisis) or whether it reflects a lasting change.

The 1990s also brought a decline in the percentage of cases that emerged from Chapter 11. Between 1980 and 1994, the rate of emergence ranged between 76% and 88%. By contrast, between 1995 and 2014, it was never more than 65%. It is possible that there is some important change in the types of cases that were filed or the way that they were treated. One hypothesis is that bankruptcy judges were tougher in later years. They were unwilling to confirm plans that allowed firms to emerge when they had too little chance to succeed. But this explanation seems implausible given that, as noted, recidivism rates have remained more or less constant with the exception of the 1994–1999 cohort.[15]

It is also possible that there are industry effects at work. During some periods, the types of firms that file might also be those that were less likely to emerge. An Internet firm that needs Chapter 11 to sort out its financial mess might be less likely to remain intact as a going concern, but this does not mean that Chapter 11 was inappropriate or done less ably. This explanation, however, seems unlikely as well, as the distribution of types of firms does not change noticeably between the two periods. There seems to be more variation among

13. *See* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2005).

14. For these purposes, I am focusing only on cases that were neither prepackaged nor prearranged. Include these cases, and the duration falls even more in the later periods.

15. See *supra* notes 10–13 and accompanying text.

the cohorts between 1980 and 1994 on the one hand and 1995 to 2014 on the other than there is between the two different time periods.

Perhaps the most striking contrast between practice in the 1980s and today is the role of old equity. Old equity actively participated in cases during the 1980s. Half of the cases LoPucki and Whitford studied had equity committees.[16] Only one in five had them in the first half of the 1990s, and only about one in ten since then. More striking, LoPucki and Whitford found that there was a distribution to equity in more than 75% of the cases they studied. Distributions to equity were commonplace even when the firm was manifestly insolvent. In every case in which general creditors received at least fourteen cents on the dollar, equity received something. This is no longer the case. By the early 2000s, equity commonly received nothing in the vast majority of cases.[17]

The small payout to unsecured creditors explains part of why equityholders fare so poorly under existing practice. Unsecured creditors received forty-one cents on the dollar in the median case filed before 1995. Afterwards, their share fell to 13%. But this itself does not explain everything. Even when distributions to unsecured creditors fell as low as 13% in a given case during the 1980s, equity often received something. This does not happen any more.

In short, these summary statistics suggest that the 1990s was a time of transformation. Chapter 11s became quicker, going-concern sales rose dramatically, the number of firms entering with at least some kind of agreement among major stakeholders became commonplace, the number of firms that emerged successfully fell, and payouts to equity became smaller. Because all these changes occur at roughly the same time, it naturally leads to the question of whether there is some underlying force that is driving these effects.

Using any large database requires understanding how the data are assembled and how the various fields are defined. One needs to be aware of what each category means. I have argued elsewhere, for example, that the BRD understates the number of firms that are transferred in bankruptcy as a going concern. Ed Lampert's acquisition of Kmart during its Chapter 11, for example, does not count as a sale under the BRD's protocols because, instead of buying the assets outright, Lampert bought the fulcrum security and then put in place a plan that gave him the equity of the reorganized company. From the perspective of the old stakeholders, there was little difference between what happened in Kmart and an outright sale.[18] But for present purposes, the absolute number of sales is not the focus, but rather their relative change over time. As long as the methodology is consistent, one can usually identify trends even if one believes that the data understate (or overstate) the relevant phenomenon.

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16. *See* LoPucki & Whitford, *supra* note 1, at 137–38.

17. The BRD does not gather comprehensive data on distributions to equity, perhaps because the phenomenon is empirically so unimportant today. In another study, Bob Rasmussen and I found that equity was unequivocally left with nothing in seventeen out of twenty-three cases that emerged from bankruptcy in 2002. In only one case did equity receive anything when an insolvent business entered bankruptcy without a preexisting deal in place. *See* Baird & Rasmussen, *supra* note 2, at 692 n.65.

18. *See id.* at 698.

Nevertheless, one must still bear in mind exactly what is being measured. Fewer firms "emerged" in the mid-1990s, but this does not mean that the outcomes became worse. A firm can enter Chapter 11 and sell its assets to another buyer in the industry. If operations are combined such that the reorganized firm loses its own identity, then the firm has not "emerged" as that term is defined in the BRD, even though the assets are being put to their highest valued use and no one has lost her job. By the same token, it is not necessary for the core business of a firm to remain intact for it to satisfy the definition of emerge. Eastern counts as a firm that successfully emerged from bankruptcy.

To return to LoPucki and Whitford's original sample, although only 10% of firms failed to emerge from Chapter 11, 45% shattered subsequently and failed to maintain their core business.[19] Even when a firm "emerges," it is common for the number of jobs to decline sharply during the course of the reorganization.[20]

With these cautions in mind, it is possible to suggest some ways to tie the changes of the 1990s together. The increase in sales seems a large part of the story. During the 1980s, senior creditors did not see Chapter 11 as an agreeable forum for the sale of their collateral. Indeed, LoPucki and Whitford have three cases in their study in which the stakeholders planned on a liquidating sale of the assets only after the bankruptcy was over.[21]

The willingness of bankruptcy courts to approve the sale of substantially all assets even in pieces might have increased during the 1990s. Such a change would increase the number of sales, shorten the length of each case, and reduce the number of firms that emerged. In the 1990s, creditors who had leverage over the debtor might therefore have become more willing to use bankruptcy as a forum to sell assets. This in turn might have led to the rise in prenegotiated and prearranged bankruptcies that we see. And in such cases in which creditors plan asset sales, equityholders can expect to fare less well. When assets are converted into cash, it is harder for equityholders to claim that there is value for them.

No doubt sales have been important. Also important was the increasing power of creditors. With rule changes in the early 1990s, it became much easier to consolidate claims.[22] It may have taken creditors a decade or so to see how to use the Bankruptcy Code to their advantage. Creditor power also expanded as courts interpreting the Code's adequate protection provisions made it harder for debtors to obtain priming liens or use cash collateral. This may not exhaust all the possible explanations. In the next Section of this Essay, I want to suggest one

19. The term "shattered" is the one that LoPucki and Whitford used to describe these firms. *See* LoPucki & Whitford, *supra* note 3, at 602.

20. The decline, however, seems to be decreasing over time. It is 44% and 50% in the first two cohorts, but ranges from 19% to 28% in all the cohorts thereafter.

21. *See* LoPucki & Whitford, *supra* note 3, at 603 n.22.

22. The rules governing the trading of claims loosened substantially in the early 1990s and the amount of claims trading increased substantially. *See* W. Andrew P. Logan III, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 501–02 (1994) (describing the decision of the Rules Committee to remove claims trading from judicial oversight to promote a liquid market in claims).

more force, one driven by norms rather than the letter of the law, that might have also been at work.

II. DIRECTORS AND STAKEHOLDERS

The initial mystery LoPucki and Whitford confronted in their study was their finding that in many cases there were distributions to equityholders that were out of step with their entitlements under the absolute priority rule. Plans were regularly confirmed in which equityholders were given an amount greater than what it would cost to cram them down and leave them nothing. Moreover, distributions went to equityholders even when there was no active committee. The equityholders who were dispersed and quiescent still enjoyed payouts.

LoPucki and Whitford found that part of the explanation was entirely pragmatic. There was the fear on the part of the directors and officers that, if they gave equityholders nothing, they would become energized and "kick sand in our faces."[23] But their interviews showed that more was at work. A central part of the story they tell, based on their interviews, is that the officers and directors believed that their duties included looking out for the interests of equity.

When LoPucki and Whitford did their interviews in the 1980s, they found that directors and officers saw part of their jobs to protect shareholders even when it was clear they were out of the money. Over time, this may have changed. New regulations, the market for corporate control, and the additional levers that creditors possess, quite apart from their direct effects, may have the independent effect of making the directors more inclined to look at the firm as a whole and all of its investors, and not just the shareholders.

The board operates inside a protected envelope. As long as each director acts within this large volume shielded by the duty of care and the duty of loyalty, she is free to do what she thinks best.[24] The exact dimensions of this envelope have changed over time, but as long as directors and officers pay attention and have no conflicts of interest, they are largely unconstrained. There is very little any constituency can do to force a court to second-guess such decisions.

There is remarkably little guidance about how the board is supposed to navigate conflicts across different stakeholders, but the way boards understood their jobs may have changed over time. Fifty years ago, directors of large corporations were often relatively passive and inclined to do the bidding of the existing CEO. It became clear in the early 1990s, however, that, at least when the firm was financially distressed, shareholders could not prevent directors from taking account of the interests of creditors.[25] The courts made it clear that it was

23. *See* LoPucki & Whitford, *supra* note 1, at 184.

24. Moreover, many corporations have insulated directors from any personal liability for failure to exercise business judgment. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2015).

25. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). As later cases made plain, it is one thing to say that a shareholder cannot prevent directors from looking after the interests of creditors when the firm is insolvent and quite another to say that a creditor can bring an action against the directors for failing to look after their interests. *See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

quite wrong to think that board members were bound to favor equityholders to the exclusion of others. Directors today therefore may think differently. Directors today may be more likely to see their duties as going to the firm as a whole, rather than to existing management and equityholders.

Board members are entirely free to take steps that have the effect of wiping out equity completely. This happens, for example, every time the board approves the filing of a voluntary prepackaged bankruptcy that gives equity nothing. By the same token, creditors have little ability to hold the directors directly liable for failing to look out for their interests. They may be able to bring derivative actions, but Delaware courts have made it plain that the duty of directors is to the firm as a whole. Directors have a "duty to maximize the value of the . . . corporation for the benefit of all those having an interest in it."[26] They must look to the underlying merits, but within very broad boundaries they are free to do what they think best.

A director who asserts that she is taking a course that is not maximizing the value of the firm's assets, whether for the benefit of shareholders or anyone else, is asking for trouble,[27] but she is most unlikely to encounter difficulty otherwise—even if a decision is likely to have little effect other than benefit one investor at the expense of another.

Quadrant Structured Products Co. v. Vertin,[28] a 2014 Delaware case, illustrates the range of discretion that directors enjoy. Athilon was an insolvent company in the course of liquidating its assets. It had no business other than holding a portfolio of securities. The directors decided to sell some of the securities and use the proceeds to purchase a bundle of securities with a higher yield and potentially a higher volatility. In an efficient capital market, the *only* ex ante effect of such a decision is to benefit junior creditors at the expense of senior creditors. Because there are always costs associated with the sale of a security, the transfer had the effect of making the firm as a whole slightly worse off.

There is no reason to believe that the more volatile portfolio was the more valuable one. Indeed, there was every reason to think the directors made the exchange to advantage the junior creditors. Indeed, the junior creditors had acquired control of the firm and had picked its directors. Nevertheless, a Delaware Chancellor does not second-guess such decisions. It is enough that, in less than perfect markets, one portfolio *might* be more valuable than the other.

Markets are imperfect, and two bundles of securities trading at the same price might not be worth the same. Directors are free to exercise their judgment

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26. *Gheewalla*, 930 A.2d at 103. The director stands in a position analogous to a trustee of a trust whose beneficiaries have conflicting interests. In the law of trusts, the trustee's obligation is to "act impartially and with due regard for the diverse beneficial interests created by the terms of the trust." RESTATEMENT (THIRD) OF TRUSTS § 79(1)(a) (2003).

27. It is worth recalling that *Lionel* is exactly such a case. The Second Circuit disapproved a sale of publicly traded securities, but only because the board conspicuously failed to identify any purpose in making the sale other than to please one group of investors at the expense of another. *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1066 (2d Cir. 1983).

28. 102 A.3d 155 (Del. Ch. 2014).

about which of two investments is worth more. The disappointed investors could not get past a motion to dismiss. *Quadrant* is a case in which the directors' decision favors the junior investors, but the logic of the opinion applies equally if the senior creditors were in control and the directors made investment decisions that favored them.

The way in which the duties of directors are voiced in Delaware may itself have influenced the way that directors view their role. The courts now emphasize that the directors must look to the interests of the firm as a whole, rather than the interests of the shareholders.[29] Directors might take their cue from such decisions, even if doing so has no effect on their potential liability. Directors may focus more on maximizing the value of the business rather than the interests of any particular constituents simply because they now have a different understanding of their jobs.

Other forces are also at work. CEO turnover is much higher. Average tenure is now six years. In an earlier era, it was much longer. As a result, more directors have picked the CEO, rather than vice versa.[30] They feel less beholden to her. Throughout this period the number of independent directors is rising. Only 10% of directors are insiders today. In 1950, it was close to half.[31] Some is this change is the result of regulatory intervention. In 2003, the Sarbanes-Oxley Act required that a majority of the board consist of independent directors. Audit committees must consist entirely of independent directors. The New York Stock Exchange now requires entirely independent nominating and compensation committees.[32]

Boards of large corporations even into the 1970s were largely insulated from external pressures. Today there is a market for corporate control. Hedge funds appear and insist on action. Modern lenders have covenants they can use to effect changes in the way the firm operates.[33] Creditors may insist on the retention of a turnaround firm or the installation of a chief restructuring officer.[34] Their presence changes the relationship of the board to the firm as well. They give the board a different perspective on the firm.

These changes have likely affected the way boards approach Chapter 11. The modern director of a hopelessly insolvent firm may be more likely to believe that equityholders are entitled to less consideration. Once a firm is sufficiently insolvent, it does not belong to the equityholders anymore.[35] If directors were

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29. See *supra* notes 25–26 and accompanying text.

30. Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1032 (2010).

31. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1468, 1473 n.9 (2007).

32. See Kahan & Rock, *supra* note 30, at 1023.

33. *See* Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. OF FIN. STUD. 1713 (2012).

34. If we look at the forty most recent large cases in which plans have been confirmed, 35% have employed turnaround firms who do repeat business with large creditors; 15% have chief restructuring officers actually installed.

35. This is not to say that modern directors ignore shareholder interests the moment a firm becomes insolvent. The equity of an insolvent firm still retains option value, and directors should take

focused on maximizing value, it would explain why the cases were faster. The changing perception of directors of their responsibility might also explain the rise in prepacks and prearranged plans. Directors might be more willing to work with creditors in advance of bankruptcy to craft a restructuring plan. A change in the director's outlook might also explain why there were more sales.[36] Indeed, the directors might have become more likely to consider value-maximizing sales, even ones that left existing CEOs without jobs. This could explain the decline in the number of cases that emerged from Chapter 11.[37]

In short, changes in the way that directors and officers regard their own responsibilities may be partially responsible for the changes that we see in the BRD. It would be worthwhile to explore the way in which directors perceive their own responsibilities and how these have changed over time. The thought experiment is to imagine how a responsible, attentive, and independent director perceives her own responsibilities.

At the same time, such thoughts need to be tempered with data, and the BRD collects comprehensive data on the fate of the CEO. Obvious patterns here do not emerge from the summary statistics. It might seem that greater creditor control would lead to more CEOs being dismissed, but once one controls for whether the firm itself survived, the speed with which CEOs have departed has not changed in a way that is manifest. Of all the data fields in the BRD, this one is the one most worthy of close scrutiny. It is data not collected elsewhere, it is comprehensive. Patterns likely lurk beneath the surface and understanding them would shed light on the dynamics of modern reorganization practice.

Academic discussions of the duties of corporate directors spend entirely too much time on how much legal rules constrain the director's discretion. Too little attention is spent on the question of what directors *should* do. It is one thing to tell a director that an individual creditor cannot sue her directly for violating a duty owed her. It is quite another to tell a director how to think about the best way to discharge her obligations as a director when the firm is insolvent and the interests of different investors have to be traded off against each other. In trying to think about this enterprise, it would be useful to see how directors and officers think about their own responsibilities and whether they have changed since the time LoPucki and Whitford did their original study.

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account of it until there is a day of reckoning. As discussed in the next Section, nothing requires bankruptcy regimes to be a day of reckoning that treats the reorganization as the equivalent of a hypothetical sale. A coherent law of corporate reorganizations can recognize the option value of every investor's stake in the firm. *See* Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011).

36. One needs to be cautious about sales, given the empirical evidence of possible inefficiencies associated with sales. *See* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007).

37. Again, one needs to be cautious, as the BRD shows only a decline in the number of cases that emerged. It is not certain that the decline is due to an increase in the number of sales in which the firm did not survive as a going concern. Nor does the BRD have any data that suggests such sales maximized value.

III. IRRELEVANCE OF PRIORITY

LoPucki and Whitford show that departures from absolute priority in the 1980s were never dramatic. The empirical evidence suggests that variations from absolute priority have fallen over time.[38] One also needs to be cautious about reported departures from absolute priority. A plan in which senior creditors consent to give value to junior creditors may result not from a failure on the part of judges to adhere strictly to absolute priority, but the opposite. A secured creditor may agree to receive less than full payment because its lien is vulnerable. If a secured creditor has a 10% chance of losing an avoidance action, a consensual plan under which it is paid only 90% of its secured claim is simply a settlement that reflects the value of its priority right. A lien that is subject to attack is not worth as much as one that is bulletproof.

The benefits of priority are elusive. Sophisticated creditors receive, after adjusting for the risks, the market return on the capital they contribute to the enterprise. A secured creditor whose priority right is limited in bad states of the world will adjust accordingly.[39] There may be some consequences to limiting priority. To the extent that a hierarchical capital structure brings benefits,[40] these are lost when priority rights are slighted. But these costs are modest to the extent that departures from absolute priority are small. The evidence suggests that they always have been. To quote LoPucki and Whitford, priority itself may be "a tempest in a teapot."[41]

Modern Chapter 11 practice is frequently a contest between sophisticated investors. There are, to be sure, some large Chapter 11s in which the renegotiation of collective bargaining agreements is a central issue. But as the economy changes and the level of unionization in the private, for-profit sector declines, it has become a smaller part of the picture. Mass tort cases or those in which fraud or pension liability are central issues have always been only a small fraction of the total cases, and they may be falling.[42]

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38. Sreedhar T. Bharath, Venky Panchapegesan & Ingrid M. Werner, *The Changing Nature of Chapter 11*, 28 (Fisher Coll. Of Bus., Working Paper No. 2008-03-003, 2010).

39. Even junior investors who invest without knowing whether other creditors prime them and are "nonadjusting" in this sense will still in expectation receive the market return on their investments. *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 887–91 (1996). There is a huge (and often neglected) difference between being nonadjusting and being undercompensated. The social cost of "nonadjusting" creditors, at least when the creditors are reasonably sophisticated, is not that they fail to account for the possibility of a secured creditor who might prime them, but rather that, in equilibrium, the level of secured credit is too high relative to the social optimum.

40. There is an extensive literature that tries to identify such benefits, beginning with Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979).

41. LoPucki & Whitford, *supra* note 1, at 126.

42. The BRD includes a data field that looks at whether tort, pension liability, fraud, or environmental liability precipitated the bankruptcy filing. They were 18% of all cases, between 1984 and 1989, but not above 10% at any other time. Since 2004, they have been less than 5%. There have been none since 2009. This understates the problem, of course, as such liabilities can matter even when they do not precipitate the case, but it does suggest that the problem is in decline.

Especially in the case of prepackaged and prearranged plans, sophisticated investors are often the only ones involved in the reorganization. The restructuring is transparent to everyone else. They are simply paid in full as if the bankruptcy never happened.[43] The senior investors who permit these payments, of course, are not charitably inclined. They are merely acting in their own self-interest. Bringing those involved in the day-to-day operations of the debtor's business into the restructuring process makes little sense when the operational obligations are sufficiently small. Moreover, even if these obligations are unsecured, they may have structural priority. This happens whenever operations are in a subsidiary and the institutional investors have debt at the parent level. Senior lenders are better off negotiating a restructuring with institutional lenders and paying others off, rather than running the risk of disrupting the operations of the firm.

Rather than priority rights, control rights are what matters. The question that should be front and center in any debate over bankruptcy reform is how they are exercised. *Residential Capital* was a remarkably successful reorganization by almost any account. It was one of the few mortgage servicers to survive the economic collapse of 2008 and its aftermath. Nevertheless, a group of secured creditors vehemently fought to increase their share under the plan.[44] The plan called for giving them the value of their secured claim in cash. They asserted that they were entitled to postpetition interest as well.

These secured creditors had weak arguments on the merits, but nevertheless spent tens of millions of dollars arguing that they were oversecured. Their behavior was not irrational. Even if their claim was not terribly strong, $400 million was at stake. Even a 15% chance of winning makes the money spent on litigation a positive net value investment. What matters is not so much the priority rights themselves, but rather the need to design a system that minimizes the cost of battling over these rights.

The issues that now dominate the Chapter 11 landscape—from going-concern sales to claims trading—are troubling not so much in their own right, but because they reflect weaknesses in the existing set of control rights. There are too many places where those with their hands on the levers of control can turn them for their own benefit in a way that is costly to the group as a whole.

LoPucki and Whitford concluded that payouts to equity were not troubling in large part because the payouts did not disrupt the Chapter 11 process. Managers in the course of forming the plan decided upon giving equity a share, but this was merely a distributional question. It did not change the way they ran

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43. The prepackaged Chapter 11 of the Indiana Toll Road in September 2014 provides an illustration. *See* Motion of ITR Concession Company LLC, et al., for Entry of Interim and Final Orders (A) Authorizing the Debtors to Pay Prepetition General Unsecured Claims in the Ordinary Course of Business, (B) Directing Financial Institutions to Honor Related Checks and Electronic Payment Requests, and (C) Granting Related Relief. *In re* ITR Concession Co. LLC, 2014 WL 4955941 at *5 (No. 14-34284).

44. Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re* Residential Capital, LLC), 501 B.R. 549, 555–56 (Bankr. S.D.N.Y. 2013).

the business or the reorganization. When there was no active equity committee, no time was spent even litigating the question or negotiating about it.

By contrast, the valuation battles that the absolute priority rule requires are especially costly. All measures of value are noisy.[45] In a heavily tiered capital structure, errors in measurement that are likely inevitable (perhaps 10% or so) can spell the difference between whether a class is paid in full or entirely out of the money. The strongest critiques of the absolute priority rule are made through this lens, especially in the typical modern reorganization in which the only players are sophisticated investors. Rigid insistence on absolute priority has the effect of pitting senior and junior creditors against each other. It is not the fact of priority among professional investors, but rather the cost of sorting it out, that creates the most difficulty.

Alternative priority regimes have the potential to mitigate or, at least in theory, eliminate this cost. The rules of the equity receivership have been subject to serious criticism, sometimes for good reason, but its allocation of control rights and the priority regime that reinforced it largely avoided the battles common to an absolute priority regime.[46] Each class was entitled to a share of the reorganized entity based on the option value of its stake in the business.

The reorganization itself was not a day of reckoning that collapsed future values to the present. If an underwater interest had a chance of being paid some day if things went well, the value of this chance would be recognized. If this value can be established at low cost, no party has an incentive to exercise control rights to fight for a larger share. Because their rights were fixed, junior and senior interests each cared about maximizing the value of the business. Conflicts that permeate modern Chapter 11 practice did not exist during the era of the equity receivership. The same lawyer could represent senior and junior classes of creditors in a reorganization at the same time.[47]

This is not to say that we should return to the world of relative priority. Such a regime works only if option values can be set at little cost. The idea of recognizing option value was first revived in recent times with law-and-economics types to whom such problems of valuation might appear easier than they are.[48] But the idea is receiving growing traction in many quarters. Indeed, the American Bankruptcy Institute explicitly advocates the recognition of option value in its bankruptcy reform proposals.[49] Absolute priority took hold only in the 1930s. The principal rationale for installing it and rejecting the priority regime that preceded it was that norms and customs supplanted law to a much greater extent than they should and that clear, hard-line rules were to be

45. *See* Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986). For Black, a market was efficient if the price at which a security traded is somewhere between half and twice its true value.

46. *See* Douglas G. Baird, *Present at the Creation: The SEC and the Origins of the Absolute Priority Rule*, 18 AM. BANKR. INST. L. REV. 591 (2010).

47. *See id.* at 596.

48. *See, e.g.*, Casey, *supra* note 35, at 764–65.

49. *See* AMERICAN BANKRUPTCY INSTITUTE, COMMISSION TO STUDY THE REFORM OF CHAPTER 11: FINAL REPORT AND RECOMMENDATIONS 207–24 (2014).

preferred. From some decades since, especially after imbibing the lessons of the Wisconsin School, this is no longer so obvious.