WHAT'S RIGHT ABOUT CHAPTER 11

WILLIAM C. WHITFORD*

In discussions about Chapter 11 and the publicly held firm, Chapter 11 is commonly assumed to have been a disaster. Eastern Airlines is the example most often given. That case is represented, accurately I believe, as a case where early liquidation would have netted creditors a substantial return but Chapter 11 was used to forestall liquidation until nearly all value in the company had been consumed in continuing losses.

There are now several different proposals to alter or replace Chapter 11 so that market forces exert greater influence on critical decisions concerning large, insolvent corporations. Most of the proposals fall into two categories: (1) a mandatory auction of assets shortly after filing;[1] and (2) a contingent equity capital structure that would automatically replace existing shareholders with unsecured creditors upon default.[2] Proposals in these categories[3] require repeal and replacement of Chapter 11 as we

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* Young-Bascom Professor of Business Law, University of Wisconsin Law School. I received many helpful comments on an earlier draft from Professor David Skeel, from the participants in the Washington University Interdisciplinary Conference on Bankruptcy and Insolvency Theory, and from my long-time collaborator, Professor Lynn LoPucki. Ms. Joan Phillips, J.D. 1994, University of Wisconsin, provided very valuable help as my research assistant.

1. This proposal is usually associated with Professors Baird and Jackson. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 209-24 (1986); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986). Professor Baird's most recent article on this topic indicates equivocation respecting his own endorsement of the proposal. *See* Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J. L. & ECON. 633, 653 (1993) ("The case for mandatory auctions is hard to make precisely because it depends crucially on a new player entering the picture who does not exist now. . . . [W]hether such people would emerge and flourish under a mandatory auction regime may be the single most important unanswered question in the law of corporate reorganization.").

2. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) [hereinafter Adler, *Financial and Political Theories*]; Michael Bradley & Michael Rosenzweig, *The Untenable Case For Chapter 11*, 101 YALE L.J. 1043 (1992). Professor Adler insists his proposal is radically different from the Bradley and Rosenzweig proposal because he would eliminate all coercive execution remedies; creditors' exclusive remedy would be to become shareholders. Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811 (1994) [hereinafter Adler, *A World Without Debt*].

3. There are other proposals to replace Chapter 11 besides the two mentioned in the text, but unless I clearly indicate otherwise, when I refer to proposed alternatives to Chapter 11, I refer only to the proposals mentioned in the text.

know it.[4]

If we can assume that the relevant markets work perfectly, it is easy to show that any of these alternative proposals would work better than Chapter 11. It is not really news that reliance on a perfect market yields better results than a regulatory scheme like Chapter 11. Comments on these replacement proposals have shown, however, that none of them are likely to work "perfectly."[5] Hence, any comparison of these proposals with Chapter 11 is a comparison of admittedly imperfect alternatives. Judgments in such circumstances are difficult, especially when one of the alternatives—the reform proposals—cannot be empirically tested. But the judgments must be made nonetheless.

The purpose of this article is to contribute to this difficult comparison. I will not focus principally on the proposed alternatives to Chapter 11. My focus instead is on Chapter 11. While certainly there are difficulties with

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One of the other proposals combines the features of the two principal proposals mentioned in the text. It would require an immediate auction but then use a complicated form of the contingent equity idea to determine which claimants would decide which auction tender to accept. Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORGANIZATION 523 (1992). Still another proposal would abolish Chapter 11 but substitute nothing in its place, permitting nonbankruptcy state and federal law to once again resolve the mess. James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097 (1990).

For an excellent summary and analysis of all proposals mentioned in the text and this footnote, see David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 472-94.

4. Another reform proposal that has been offered would permit debtors at the time of credit extension to waive their statutory right to file bankruptcy. Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595 (1993); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992). Since this proposal would permit Chapter 11 to continue to exist in its present form, my comments in this paper are quite consistent with it. I do not contend that Chapter 11 is always the superior method of resolving a corporation's debt problems. The waiver proposal does raise two critical questions that would have to be resolved before it could be adopted, however: (1) some provision would need to be made to protect involuntary creditors of debtors who had waived Chapter 11; and (2) during the transition period to a choice-based system, some provision would need to be made to protect existing shareholders and/or creditors against opportunistic conversions from a regime based on Chapter 11 to another regime for resolving creditor-debtor conflict. In my judgment, adequate solutions to these problems have not been suggested in the existing literature. If adequate solutions could be found, I have no personal objection to a choice-based system for large corporations.

5. *See* David A. Skeel, Jr., *supra* note 3, at 472-94; Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 379-86 (1993); Edward I. Altman, Comment, *Evaluating the Chapter 11 Bankruptcy-Reorganization Process*, 1993 COLUM. BUS. L. REV. 1, 10-12 (critiquing the Bradley and Rosenzweig proposal); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992).

Chapter 11 as practiced, I believe it has some unrecognized or underemphasized virtues, virtues that will be lost if Chapter 11 is replaced in one of the radical ways that has been proposed.[6]

I. GETTING THE FACTS STRAIGHT ABOUT CHAPTER 11

Because Chapter 11 exists and there have been empirical studies about how it works, we know much about its deficiencies. The early literature about Chapter 11 speculated about many deficiencies. We now know that many of these deficiencies are not as serious as once supposed. Because the contemporary literature about Chapter 11 does not always reflect this learning, however, I first set the record straight in several respects.

A. Direct Costs

There has been much lamenting about the direct costs of a Chapter 11 reorganization. The image presented is that in Chapter 11 lawyers and investment bankers consume much of the value that could have been distributed to creditors and/or shareholders.[7] In cases involving smaller corporations, direct costs commonly represent a sizeable percentage of the bankruptcy estate. It is now well established, however, that for the average Chapter 11 case involving a large corporation, direct costs, although large in absolute amount, represent only a small percentage of the assets of the corporation.[8] In most cases, distributions to creditors are not seriously diluted by direct costs.

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6. My article is in the spirit of Professor Elizabeth Warren's recent essay on bankruptcy policymaking. Warren, *supra* note 5. Both of us emphasize that in practice Chapter 11 fulfills many different functions. There is no single model of an ideal Chapter 11 case. Warren emphasizes that there are many different values reflected in Chapter 11. My analysis accepts the usual assumption that allocative efficiency concerns should be the predominant concern in Chapter 11, at least for large corporations. I believe, however, that this goal is achieved in different ways in different circumstances. I would argue that many of the different "values" that Warren identifies as goals of Chapter 11 are presumptions of the allocatively efficient result in some particular circumstance. Hence, any differences between Professor Warren and myself may be largely semantic.

Professor Warren and I are further in agreement that allocative efficiency, as important a concern as it is, is normally incapable of providing a single, determinate answer to any particular policy problem. *See* Warren, *supra* note 5, at 340. That does not excuse us from making as educated a guess as possible about what would be the most efficient solution.

7. For a recent expression of this view in the popular press, see Alison Leigh Cowan, *The Bankruptcy Business Hits Hard Times*, N.Y. TIMES, Jan. 12, 1994, at A1.

8. The most commonly cited study is Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 286 (1990) (finding that direct costs are an average of 3% of assets in sample of large cases).

Two other points should be made with respect to the direct costs of Chapter 11. First, in concept, direct costs refer only to costs caused by the bankruptcy proceeding, but in practice, direct costs are measured by the fees for lawyers and investment bankers approved by a bankruptcy court as a cost of administration. It is likely that the latter include fees that would have been incurred in the absence of bankruptcy. For example, creditors monitor loans in virtually all circumstances, and particularly as a debtor approaches financial difficulty. After filing, many creditors rely on the professionals employed by the creditors' committee to undertake much of the monitoring they would have done in any event. To the extent they do, the costs of this monitoring will be reported as a direct cost of the bankruptcy.

Second, consideration must be given to the direct costs that would be associated with the proposed alternatives to Chapter 11. In today's world there will be substantial attorney fees connected with any reorganization of the ownership of the assets or shares of a large corporation. With respect to the contingent equity proposal, greater care will be needed in drafting the default provisions of the original loan agreements,[9] and default may be followed with contested elections for the board of directors, as the new shareholders may prefer new leaders. With respect to the auction proposal, consideration needs to be given to the costs of preparing bids, many of which will be unsuccessful. No scheme will reduce the direct costs of reorganization to zero, and whether the costs of alternatives are less than the costs of Chapter 11 is problematic.

B. *Deviations from the Absolute Priority Rule*

In the early years of Chapter 11, speculation was widespread that confirmed plans would provide distributions to junior interests substantially in excess of their entitlements under the absolute priority rule.[10] Empirical research establishes that deviations from the absolute priority rule are common in confirmed plans.[11] The same research also establishes, however, that for large, publicly held corporations the size of these

9. Professor Adler discusses this problem in his contribution to this Symposium. Adler, *A World Without Debt, supra* note 2, at 817.

10. *See, e.g.,* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

11. Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457 (1990); Weiss, *supra* note 8; 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, 166-67 (1990) [hereinafter LoPucki & Whitford, *Bargaining*].

deviations is relatively modest.[12]

Some commentators have questioned whether deviations from the absolute priority rule should be considered a source of inefficiency in bankruptcy reorganization.[13] If there are efficiency losses, the most likely source is a reluctance by the most efficient investors to participate in the financing of large corporations because bankruptcy does not fully respect their preferred priority rules (presumed to be reflected in the absolute priority rule). It is possible that those losses are huge, but it seems unlikely. Given the modest magnitude of the deviations from the absolute priority rule, it is more likely that resulting welfare losses, if any, are also modest. If Chapter 11 is to be scuttled in favor of another scheme, the benefits of the switch are going to have to come largely from some other source of inefficiency.

C. *Management Loyalty to Itself and/or Equity*

Some commentators, such as Bradley and Rosenzweig, have identified self-seeking management conduct as a main source of inefficiency in Chapter 11.[14] Empirical evidence has now conclusively established that management turnover in Chapter 11 is extraordinarily high and that frequently the turnover is initiated by creditor pressure.[15] Furthermore, there is little evidence of extraordinary management compensation or other kinds of management "grabs" during reorganization proceedings.[16] There are evidently substantial checks on self-seeking management behavior in a Chapter 11 proceeding.

Commentators sometimes also assume that management loyalty in

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12. In our study of 43 completed reorganizations, we found very few cases in which the value of property interests distributed under a confirmed plan in deviation from the absolute priority rule exceeded 10% of the value of the total distribution to unsecured creditors and shareholders under that plan. In most cases the deviation was far less than 10%. LoPucki & Whitford, *Bargaining*, *supra* note 11, at 142, 166 tbls. III & IV. Similar conclusions are reached in Eberhart et al., *supra* note 11.

13. Randal C. Picker, *Voluntary Petitions and the Creditors' Bargain*, 61 U. CIN. L. REV. 519, 536 (1992); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 194-95 (1989).

14. Bradley & Rosenzweig, *supra* note 2, at 1050-52.

15. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723-42 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*].

16. *Id. See also* Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 J. FIN. 425, 426 (1993) (finding that many CEOs who stay in power during a Chapter 11 reorganization have their salaries and bonuses reduced during the bankruptcy proceeding).

Chapter 11 is to the equity class, and that management uses its influence in the proceeding to favor this class' interests. Exclusive loyalty to equity classes for an insolvent corporation is inappropriate, because equity has nothing to lose and everything to gain from a high-risk investment strategy.[17]

The assumption that management remains loyal to the equity class seems to be based on the failure of bankruptcy to change the way boards of directors are selected. Although it may be desirable that creditors participate in the selection of directors after insolvency,[18] the failure to provide formally for such participation does not necessarily mean that management will be loyal to the equity classes in Chapter 11. Outside bankruptcy it is commonly assumed that neither shareholder elections of directors nor the law of fiduciary duties is sufficient to insure management loyalty to equity interests. Hence, elaborate theory has been constructed about how the market for corporate control, management compensation systems, and the labor market for management combine to control "agency costs."[19] A little reflection will quickly reveal that few, if any, of these controls on management behavior operate in the same way within Chapter 11.[20] Furthermore, even shareholder elections of directors can be enjoined after filing.[21] Finally, there are many direct bankruptcy court controls over management actions in Chapter 11.[22] Because creditors are much more likely than shareholders to be well organized in a Chapter 11 proceeding, they are more likely than shareholders to influence the bankruptcy judge to act in their interests. In sum, there is little reason a priori to expect management loyalty to shareholder interests in a Chapter 11 proceeding.

Professor Lynn LoPucki and I made an empirical effort to assess the loyalties that managers have in fact manifested in Chapter 11 cases involving large, publicly held companies. After an intensive study of forty-

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17. LoPucki & Whitford, *Corporate Governance*, *supra* note 15, at 682-87. Of course, to the extent there are deviations from the absolute priority rule, these incentives are lessened.

18. *See* David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 494-517 (1992).

19. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

20. *See* LoPucki & Whitford, *Corporate Governance*, *supra* note 15, at 694-715.

21. *In re* Johns-Manville Corp., 66 B.R. 517, 542 (Bankr. S.D.N.Y. 1986).

22. For example, bankruptcy courts have the power to approve or disapprove new borrowing or the sale of assets not in the ordinary course of business. 11 U.S.C. §§ 363-364 (1988).

three large cases, we felt able to characterize the management behavior in twenty-five of the cases as either (1) aligned with creditors; (2) predominantly concerned with maximizing the estate; (3) predominantly concerned with preserving the company from liquidation; or (4) aligned with equity.[23] In only five of the twenty-five cases did we characterize management as aligned with equity, and in three of those cases the company was solvent. Among insolvent companies, management aligned itself much more frequently with creditor interests than with shareholder interests.[24]

D. *What is Wrong with Chapter 11*

I believe that management behavior is a big problem in Chapter 11, but not for the reasons just discussed. The primary problem is that during the often prolonged period of a Chapter 11 proceeding,[25] management is under such conflicting pressures with respect to investment policy that it frequently fails to act in a way that will maximize the wealth of the corporation. There is a tendency for management to resist quick liquidation of the firm, which often would eliminate hope of any recovery by junior interests, while simultaneously avoiding risky new investment opportunities, which could jeopardize anticipated distributions to senior creditors. The resulting paralysis of the firm's investment policy is likely to be a major source of indirect bankruptcy costs. For this reason, the time spent in Chapter 11 is a major concern. A successful resolution of the financial difficulties that have caused insolvency will relieve management from the conflicting pressures that produce this paralysis, and the quicker that happens the better.[26]

II. TELLING TALES: COUNTERVAILING ANECDOTES

Storytelling has emerged as a recognized form of legal scholarship. Stories have the capacity to describe a process in fuller complexity than

23. LoPucki & Whitford, *supra* note 15, at 742-47.

24. *Id.* at 745. *See also* David T. Brown et al., *Asset Sales by Financially Distressed Firms*, 1 J. CORP. FIN. 233 (1994) ("Our results suggest that creditors influence the liquidation decisions of financially distressed firms.").

25. *See* Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. 729, 743 (collecting studies which dated time in Chapter 11 for publicly held companies from 16-32 months).

26. The thesis presented in this paragraph was developed and defended in much greater detail in LoPucki & Whitford, *Corporate Governance*, *supra* note 15. *See also* Lynn M. LoPucki & William Whitford, *Compensating Unsecured Creditors for Extraordinary Bankruptcy Reorganization Risks*, 72 WASH. U. L.Q. 1133 (1994).

analytically oriented scholarship. Well told and dramatic stories can also influence our perceptions about what is typical. In large-case Chapter 11 scholarship, the tale of Eastern Airlines is often presented as if it were the typical Chapter 11 case.

Eastern Airlines happened, and it was a travesty. But it was not a typical large Chapter 11 case. In this section, I present three other stories about large Chapter 11 cases.[27] The outcomes of all three cases were generally regarded as successful by the parties directly involved. My purpose is to provide alternative holistic accounts of large Chapter 11 cases, so that Eastern Airlines is no longer the only well-known story.[28] However, I do not hold out these cases as typical. There is no such thing as a typical large Chapter 11 case; there is too much variety.

A. AM International

AM International has long specialized in the manufacture and distribution of graphics equipment. When it filed a Chapter 11 proceeding in April, 1982, it claimed $500 million in assets. Its financial difficulties stemmed from a rapid expansion program in the late 1970s that resulted in a large debt load. By mid-1981 it had become clear that these acquisitions were ill-advised. Management was replaced. The company simultaneously began divesting the newly acquired assets, using the proceeds to pay down debt, and renegotiating its long-term debt. When unsecured bank creditors threatened to repossess unless they received collateral, the company initiated a Chapter 11 proceeding.

The first year of the Chapter 11 proceeding focused on continued divestiture of unwanted assets and on introducing cost controls. Not until the company returned to operating profitability, about one year after filing, did serious negotiations on a reorganization plan begin. The Board of Directors, which included several large shareholders, actively participated in these negotiations; no equity committee was ever requested or appointed. The negotiations with the creditors' committee, which was dominated by bank creditors, focused principally on two main issues: (1) the amount of cash, as opposed to notes and shares, that creditors would receive; and (2)

27. The stories are drawn from the empirical study of 43 large Chapter 11 cases that I conducted with Lynn LoPucki. For a description of the sources of information used in this study, see LoPucki & Whitford, *Bargaining*, *supra* note 11, at 134-37.

28. Still another story, concerning Federated Department Stores, is provided by Professor Kaplan in his contribution to this Symposium. Steven N. Kaplan, *Federated's Acquisition and Bankruptcy: Lessons and Implications*, 72 WASH. U. L.Q. 1103 (1994).

the number of shares in the reorganized company that would be retained by equity. In the end the company agreed to borrow additional money on a secured basis to fund a larger cash payout to creditors, and creditors agreed to support a plan that allowed equityholders to retain thirty-six percent of the shares.[29] On this basis a reorganization plan was confirmed two years, four months after filing.

Creditors received a distribution worth, at confirmation, eighty-six cents per dollar owed, the vast majority of it in cash. If creditors had received all the shares, they would have received full payment, so there was a substantial deviation from the absolute priority rule in this case. However, because the company did well on the stock market after confirmation,[30] creditors who retained and later sold the shares they received in the distribution received the equivalent of full payment.

The company remains a viable entity today. In 1993 it filed a prepackaged Chapter 11,[31] with its reorganization plan being confirmed less than five months after filing.[32] In this second reorganization, shares were issued to substitute for debentures that the company issued two years after confirmation of its first reorganization plan. These debentures were issued to finance acquisitions that it was hoped would help the company use net operating losses that survived the first reorganization.

In sum, AM International appears to be a classic reorganization. The company faced cash liquidity problems while it coped with the effects of some bad business decisions. When some creditors sought to encumber assets, the company filed Chapter 11 to gain the benefit of the automatic stay, while continuing the business and the financial reorganization that had begun one year before filing. That reorganization was successfully completed, with creditors ultimately receiving more than had been anticipated when the extent of the company's financial problems was first recognized. At no time in the proceeding did the creditors' committee,

29. In effect, the company ultimately agreed to encumber its assets as originally demanded by its bank creditors. But it did not encumber its assets as fully as originally demanded, and the encumbrance was for the benefit of all creditors, not just the bank creditors. Because the plan deviated from the absolute priority rule, it could only be confirmed with the approval of all classes of unsecured creditors. 11 U.S.C. § 1129 (1988).

30. In October 1984, when shares were first distributed under the plan to creditors, AM International traded at 2⅞. STANDARD & POOR'S CORP., SECURITY OWNER'S STOCK GUIDE 14 (Nov. 1984). One year later the stock traded at 4½. *Id.* at 14. In April 1986, it peaked at 7¾. STANDARD & POOR'S CORP., SECURITY OWNER'S STOCK GUIDE 14 (May 1986).

31. *AM International Files for Reorganization, Sees Quick Recovery*, WALL ST. J., May 18, 1993, at A12 (reporting on the bankruptcy filing).

32. CHI. TRIB., Sept. 30, 1993, Bus. Sec., at 1 (reporting on confirmation of the plan).

dominated by sophisticated commercial bankers, suggest sale of the company as a unit (as in an auction), though throughout the proceeding it was understood that most of the company's more recent acquisitions would be sold.[33] Postconfirmation financial difficulties were primarily caused by ill-advised postconfirmation borrowing, and not by inadequacies in the capital structure provided by the reorganization plan.

B. Baldwin-United

Originally a piano manufacturer, in the 1970s Baldwin-United (Baldwin) became a diversified financial services company. By the late 1970s, Baldwin had become the nation's largest seller of single premium deferred annuities (SPDAs), a popular investment vehicle for wealthy individuals. Baldwin developed accounting practices that generated considerable tax losses from the sale of SPDAs, and to utilize these losses it needed to acquire profitable businesses whose income could be sheltered by the SPDA tax losses.[34] To finance these acquisitions, Baldwin relied on extensive public and private borrowings as well as the cash generated by SPDA sales.

By the spring of 1983, Baldwin was unable to keep up debt payments on the borrowings incurred to finance its many acquisitions. Negotiations between creditors and the Board of Directors led to a decision to liquidate the company as expeditiously as feasible. The management that had overseen the company's growth was replaced with Victor Palmieri & Associates, a highly respected corporate liquidator.

Liquidation was not simple. By this time, most of the stock of Baldwin subsidiaries had been pledged to the subsidiaries which sold the SPDAs. This had been done because Baldwin had been using the annuity premiums received by the SPDA subsidiaries to meet its debt payments, and the insurance commissioners in the states in which the SPDA subsidiaries were

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33. It is sometimes speculated that one reason for secured credit is that it gives the secured creditor a special incentive to monitor its collateral, with all creditors benefiting from the increased monitoring. *See generally* Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992). In the case of AM International, the company avoided granting security interests during the proceeding, but the price it paid was the surveillance of the bankruptcy court and an active creditors' committee. This surveillance may have substituted for the increased monitoring that granting the requested security interests may have occasioned.

34. The return promised to investors in the SPDAs exceeded the return that Baldwin could reasonably expect from investing the annuity premiums. Baldwin's strategy was to finance the difference through the tax savings on the other investments. Hence, the acquisition program was a critical part of the SPDA business.

located (Indiana and Arkansas) had insisted on the stock pledges before transfer of the premium cash. Before any liquidation could occur, these stock pledges had to be redeemed. In the meantime, however, the insurance commissioners had put the SPDA subsidiaries into receivership and were asserting large claims against Baldwin, as the parent corporation, for various alleged misdeeds in the management of its SPDA subsidiaries.

Before negotiations between Baldwin management and the receivers of the SPDA subsidiaries could be completed, the company filed Chapter 11 to prevent a group of unsecured creditors from obtaining a security interest.[35] Negotiations continued with the receivers and a settlement eventually was reached which resulted in the return of the stock of many of Baldwin's subsidiaries to Baldwin. Liquidation of the parent company could then proceed and did so at an expeditious pace. Simultaneously, management led extremely complicated negotiations among creditors concerning distribution of the proceeds of this liquidation. This problem was complex because of the many levels of subsidiaries, with different creditors having extended credit to different subsidiaries. Compromises of many legal claims had to be reached before these negotiations could be concluded.

A reorganization plan was confirmed twenty-nine months after filing. By this time, most of the assets had been sold. There were a few assets for which Palmieri & Associates could not find a buyer at what it considered a fair price, so these assets were preserved and stock in the reorganized company distributed pursuant to the reorganization plan.[36] Unsecured creditors received an amount far in excess of what had been anticipated when the prefiling agreement to liquidate was reached between creditors and the company.[37] The reorganized company, renamed PHLcorp., Inc.,

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35. The security interest had been granted to certain banks by previous management as part of a standstill agreement to forestall pending litigation. Bankruptcy was filed just before expiration of the period for challenging that security interest as a preference. New management was preparing to file a voluntary bankruptcy petition after collapse of negotiations with this group of banks for cancellation of the security interest when other unsecured creditors brought an involuntary proceeding.

36. The value of the stock in the reorganized company represented only 5% of the estimated value of Baldwin's assets at filing. Lynn M. LoPucki & William C. Whitford, *Patterns in the Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597 app. 2, at 615 (1993) [hereinafter LoPucki & Whitford, *Patterns*]. It is evident, therefore, that most of the assets were sold.

37. .Unsecured creditors received an average of 54 cents per dollar owed in cash and securities under the reorganization plan. Shareholders also received a small distribution, for reasons that are unclear. Unlike in AM International, Baldwin management did not negotiate actively on behalf of shareholder interests. Although management suggested a distribution to equity, apparently as a way of facilitating a consensual confirmation process, management was clearly unconcerned about how the

was taken over through share purchase shortly after confirmation and remains a viable company today.

In sum, Baldwin-United stands for the use of Chapter 11 as a vehicle for controlled liquidation. It is very likely that sale of the company as a unit at the time bankruptcy was initiated would have yielded a much less favorable result for claimants in the proceedings. Given the uncertain outcome of the negotiations with the receivers of the SPDA subsidiaries, and the complexity of the legal situation, independent bidders would probably not have invested enough in information acquisition to justify anything more than a low bid. An auction would also have been unlikely to realize the value obtained for the last few assets by keeping them in the reorganized company when no buyer willing to pay an adequate price was found.

C. *Revere Copper & Brass*

Revere Copper & Brass (Revere) was a long-time manufacturer and distributor of metal products, primarily aluminum, brass and copper products. In the 1960s it made a major investment in an aluminum ore reduction plant and a sheet mill, located together in Alabama. Never able to operate the plants profitably, Revere closed the reduction plant in 1982 after suffering large losses in the recession of the early 1980s. This left the company with three pressing financial problems in connection with the Alabama investments: (1) continued payments on industrial bonds issued in connection with the reduction plant and sheet mill; (2) an unfavorable labor agreement at the sheet mill; and (3) damages claims resulting from breach of unfavorable long-term supply contracts with TVA and ALCOA for the supply of electricity and raw materials to the reduction plant. The supply contracts had been breached with the closing of the plant.

These financial pressures led to the filing of a Chapter 11 petition in October 1982. The first two years of the reorganization were preoccupied primarily with resolving the problems resulting from the disastrous Alabama investments. First, a new collective bargaining agreement was reached, reducing labor costs at the sheet mill. About a year later Revere was finally able to sell the sheet mill, with the buyer taking over the industrial bond payments in connection with that mill. The reduction plant

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proceeds of its efforts were divided among the various claimants. Management had been hired to liquidate a clearly insolvent company, and it viewed its sole obligation as doing so in the most efficient way possible.

was never sold, and provision for its bondholders ultimately had to be made in the reorganization plan.

Before serious efforts were made to negotiate that plan, however, settlements were reached with TVA and ALCOA on their claims. TVA had been claiming $102 million but settled for a cash payment of $8.6 million and an unsecured claim of $24.6 million. ALCOA had been claiming $110 million but settled for an unsecured claim of $20 million. Until compromised, these claims represented over fifty percent of asserted claims in the bankruptcy.

Once the TVA and ALCOA claims were compromised, negotiations concerning a reorganization plan began. Because metal prices had recovered, the company was doing better financially. In addition, because it had suspended payment on publicly held debt during the bankruptcy, it had been able to accumulate a considerable amount of cash. In the negotiations it was agreed that all classes of creditors would receive full payment in some combination of cash, notes and shares, but there was tremendous conflict about who would get cash. In the end, unsecured bank creditors and trade creditors received the greatest portion of the cash, with the reduction plant industrial bondholders receiving a lesser portion.[38]

After confirmation the company did well. A little more than one year after confirmation the company was acquired by an investor group through a tender offer.[39] The tender price was approximately 150% of the trading value of the company's shares immediately after confirmation. Approximately eighteen months later, the company was acquired by Corning Glass Works.[40]

In sum, Revere used its time in Chapter 11 to resolve long-standing problems connected with a large and disastrous investment.[41] I do not know whether it would have been possible to resolve those problems as

38. Trade creditors were provided an option to receive 65% of their claims in cash if they waived the balance, and most trade creditors accepted this option. Otherwise, trade creditors, along with the bank creditors, TVA, and ALCOA, received about 40% of their claims in cash, with the balance in short- and long-term notes and shares. Bondholders received lesser cash payments and no postpetition interest. The indentured trustee under the bond indenture believed that the bondholders were not equitably treated, but the plan won the necessary vote for confirmation nonetheless.

39. *Revere Takes $203 Million Bid*, N.Y. TIMES, Nov. 19, 1986, at D5.

40. *A Marriage of Ceramic, Metal: Corning to Buy Revere Ware*, CHI. TRIB., May 1, 1988, Bus. Sec., at 7.

41. Unlike in many Chapter 11 reorganizations, Revere's management was not forced out during the proceeding. Toward the end of the proceeding, Revere's long-time CEO retired, staying on as Chairman of the Board until after confirmation. However, this retirement was not forced in any way.

successfully outside bankruptcy.[42] Once those problems were resolved in Chapter 11, however, a reorganization plan was devised that provided full payment, or nearly so, to all creditors, and the company did well thereafter.

III. THE MANY USES OF CHAPTER 11

The proposed alternatives to Chapter 11 all presuppose that the purpose of Chapter 11 is to reorganize a financially troubled company, much as occurred in AM International. My thesis in this section is that while reorganization is certainly one purpose which Chapter 11 can and does serve, Chapter 11 has come to be used for several other quite different purposes. Discussions of the proposed alternatives to Chapter 11 have taken little account of Chapter 11's alternative uses. If these proposed alternatives could not be adapted to achieve the purposes other than reorganization which Chapter 11 now serves, replacing Chapter 11 with any of these alternatives would deprive the legal system of one practical way to achieve these ends. To the extent that use of Chapter 11 for these other purposes achieves socially beneficial results, replacing Chapter 11 in order to better achieve the reorganization goal would be analogous to throwing out the baby with the bath water.

A. Controlled Liquidation

As the Baldwin-United case makes clear, one alternative use of Chapter 11 is controlled liquidation. In an earlier article Professor LoPucki and I pointed out that virtually all large Chapter 11 cases involve extensive liquidation of assets.[43] We questioned the classic distinction between reorganization and liquidation: "The meaningful distinction is among various degrees of liquidation, not between reorganization and liquidation as discrete categories."[44] Liquidation, however, generally takes place in discrete units. Rarely is a company, or that part of it to be liquidated, sold as a whole unit. Rather it is "packaged" in different parts, which are sold

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42. In the interviews Professor LoPucki and I conducted about this case, our interviewees were not well informed about what leverages proved influential in the ALCOA and TVA settlements. The lawyers we interviewed had negotiated the reorganization plan but had not been actively involved in the earlier negotiations leading to the compromise of the TVA and ALCOA claims. We do not know for sure, therefore, whether peculiar features of Chapter 11 played a large role in producing those compromises, though it is certainly possible that they did.

43. LoPucki & Whitford, *Patterns*, *supra* note 36, at 605-06.

44. *Id.* at 606. Even in AM International, the asset size of the company at confirmation was only 60% of its asset size just before filing. *Id.* app. 2, at 615.

separately. Even where it is understood at filing that complete liquidation will be the basic strategy for resolving the financial mess, asset sales commonly take place over a period as long as a year or more.[45]

The proposed alternatives to Chapter 11 presuppose markets perfect enough that the claimants to a bankruptcy proceeding would reap the gain to be made by packing the assets into discrete parts rather than selling them as a single unit, even though the packaging would not take place as part of the reorganization proceeding. Imagine, for example, an auction, one of the proposed alternatives. If ultimately it is more efficient to break up the company, with different enterprises operating different units, the buyer of the company at the auction would do the repackaging, but the price bid at the auction would reflect the gains to be achieved by repackaging the company into more efficient parts. In a perfect market the auction buyer would receive only a competitive fee for its service in repackaging the company and finding buyers.

If this supposition is correct, the question becomes why an auction approach is not used more often in Chapter 11. There are a number of possible answers, and no doubt the reason is not the same in every case. Sometimes management may be struggling desperately to hold onto its empire, perhaps in hopes that lightning might strike and turn ashes into gold. Whatever liquidation occurs is done grudgingly and involves as few assets as possible. In other situations, however, I am convinced that liquidation occurs in a controlled way because appropriately motivated management, often acting with the agreement of creditors, determines that controlled liquidation will maximize the return to the claimants to the proceeding. Baldwin-United is a classic example of such a case. The creditors and the Board of Directors agreed that the assets of the company should be liquidated as rapidly as possible for distribution to claimants, but rather than arrange for an auction, they agreed upon retention of an experienced corporate liquidator to dispose of the assets over time.[46]

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45. LoPucki & Whitford, *Corporate Governance*, *supra* note 15, at 760-61 tbl. VIII. *See also* Warren, *supra* note 5, at 350-52 (citing "orderly liquidation" as one function of business bankruptcy).

46. The reasons why an auction might yield an inadequate price are explored in more depth in LoPucki & Whitford, *Corporate Governance*, *supra* note 15, at 758-65. An important possible reason is the tremendous information costs associated with preparing a bid for an auction—a bidder must study a company and determine for what amount it might be resold in "packages." When the cost of preparing bids is high, the number of bidders is likely to be few, and risk-averse bidders are likely to bid low. For this reason, it is common in Chapter 11 cases for management to "clean" the assets before putting them up for sale. "Cleaning" the assets means separating them from uncertain liabilities. This makes it easier for prospective bidders to assemble the information needed to make a competitive bid,

For the same reasons that we are concerned about deviations from the absolute priority rule,[47] we should be concerned about any procedure for liquidation that unnecessarily reduces the return to claimants. Creditors undoubtedly extend credit on the assumption that liquidation will be conducted in a way that maximizes their return. Deviating from the "deal" made at the time of credit extension may cause efficiency losses, just as deviating from the contractual priority scheme may do so.

If controlled liquidation is sometimes superior to an immediate auction for this reason, it is self-evident that something like Chapter 11 is needed. The key is the automatic stay. Without the automatic stay, it is not possible for management to package the assets in useful ways and market them to prospective buyers. Rather, squabbles between the claimants about the division of the proceeds (and perhaps also about the best way to package the assets) will cause some group of claimants to try to seek an advantage by obtaining a security interest or forcing a foreclosure sale, either of which can force an *un*controlled liquidation. This is, of course, simply a restatement of the usual justification of bankruptcy as a collective creditor proceeding that avoids a common-pool problem.

The contingent equity proposal is not subject to the same objections in this respect as is the immediate auction proposal. Providing creditors are restricted from resort to coercive execution remedies,[48] controlled liquidation would presumably occur under such a scheme whenever it would yield a higher return than alternative uses or dispositions of the debtor's assets. But it is unclear whether the benefits of controlled liquidation would go to the most appropriate claimants. Suppose that the premium from controlled liquidation is sufficient to justify some recovery under the absolute priority rule by classes other than senior creditors, but that those junior classes would not receive any recovery in the absence of a controlled liquidation. Under the contingent equity proposal, these junior classes will receive a benefit only if within a relatively short time period they recognize the benefits of a controlled liquidation and somehow raise enough money to pay off the senior creditors. If financial markets are perfect enough, somebody will furnish enough capital to junior classes to finance this transaction, as well as to organize the dispersed holdings in the junior classes, since there is a profit to be made. But, of course, if markets

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and reduces the discount for risk in bids by risk-averse bidders.

47. *See supra* notes 10-13 and accompanying text.

48. Professor Adler distinguishes his proposal from Professors Bradley and Rosenzweig's on precisely this point. *See supra* note 2.

were this perfect, the immediate auction would also yield a bid capturing the benefits of controlled liquidation for prefiling creditors. If, in a contingent equity scheme, junior creditors are unable to capture the benefits of controlled liquidation in the circumstance described above, those benefits would go as a windfall to senior creditors, and that class would ultimately receive more than the value of their prefiling claims. As argued above, the potential inefficiencies resulting from this distribution are the same as those that result from any deviation from the absolute priority rule under the current legal regime.[49]

B. *Using Bankruptcy Creatively*

There is a group of Chapter 11 cases involving large, publicly held companies in which a principal purpose of the proceeding is avoidance or minimization of a particular obligation (or set of related obligations). There are quite a number of cases that fall into this pattern: (1) the mass tort cases, such as Johns-Manville and A.H. Robins; (2) the spectacular judgment cases, such as Texaco or Smith International;[50] (3) the environmental cases, where CERCLA liability is sought to be discharged;[51] (4) the pension liability cases, such as LTV;[52] (5) the collective bargaining cases, such as Continental Airlines; and (6) cases where relief from a crippling long-term contract was a central goal of the bankruptcy proceeding, such as Revere Copper & Brass.[53]

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49. *See supra* text accompanying note 47.

50. The Smith International case was very similar to the Texaco case, though not so well known. Smith International was a defendant in a patent infringement action brought by Hughes Tool Co. The trial court entered a verdict of $205 million, an amount far in excess of Smith's anticipations. Eileen White, *Smith International Is Told It May be Forced to Pay As Much As $205 Million*, WALL ST. J., Feb. 18, 1986, at 6. Smith then filed a Chapter 11 proceeding. The primary motive for the filing was to gain leverage in settlement negotiations. One important source of leverage was the automatic stay, which prevented Hughes from obtaining a judgment lien. Eighteen months later a settlement of the patent infringement claim was reached for $95 million. The other claimants in the proceeding then quickly reached agreement on a reorganization plan.

51. For recent accounts of litigation concerning the dischargeability of environmental obligations in bankruptcy, see Kathryn R. Heidt, *The Changing Paradigm of Debt*, 72 WASH. U. L.Q. 1055 (1994); Shawn F. Sullivan, *Discharge of CERCLA Liability in Bankruptcy: The Necessity for a Uniform Position*, 17 HARV. ENVTL. L. REV. 445, 467-92 (1993).

52. For a recent discussion of the Pension Benefit Guaranty Corporation's role in these cases, see Daniel L. Keating, *Chapter 11's New Ten-Ton Monster: The PGBC and Bankruptcy*, 77 MINN. L. REV. 803 (1993).

53. *See supra* text at pp. 1390-92. The single asset cases where a debtor seeks to rewrite a mortgage obligation (usually on real estate) are another example of creative bankruptcy, as I use the concept. However, this fact situation is not likely to show up in cases involving large, publicly held

There seems something opportunistic about using bankruptcy creatively. If a company's financial fortunes would not be so bleak but for one problem, use of the bankruptcy laws for the primary purpose of resolving that one problem can be seen as use of the bankruptcy laws for something other than their primary purposes.[54] In the corporate area those primary purposes are generally assumed to be reorganization of a complex debt structure, or as an efficient liquidation procedure, or some combination of both. Many observers undoubtedly believe that it is more appropriate for these other problems to be resolved only outside bankruptcy.[55] Otherwise, there inevitably is an incentive to file bankruptcy by whatever interests are better served by the bankruptcy alternative. Such "forum shopping" has long been considered very undesirable by a number of leading commentators.[56]

The fact remains, however, that in most of the instances in which a creative use of bankruptcy has been attempted, the corporation faced a problem that jeopardized its future viability. In such situations, failure to resolve the problem can lead to less than socially optimal corporate decisionmaking. For example, if a corporation is deeply insolvent, management can identify its self-interest with highly risky business strategies. Management may fear that its business reputation will be forever damaged because of the financial troubles unless the corporation can strike it rich quick.[57]

In the mass tort cases, absent some solution such as was devised in Johns-Manville or A.H. Robins, the corporation may act on the shareholders' theoretical interest in quick liquidation before the full extent of tort liability can be determined.[58] Alternatively, and probably more

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corporations.

54. See ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXT, CASES, AND PROBLEMS 786-88 (2d ed. 1991) ("[B]ankruptcy proceedings have been increasingly used . . . to solve relatively specific legal problems."); *In re* Johns-Manville Corp., 36 B.R. 727, 741 (Bankr. S.D.N.Y. 1984) (denying motion to dismiss bankruptcy proceedings on the basis that it was inappropriate to use bankruptcy to resolve the company's mass tort difficulties).

55. *See, e.g.*, Adler, *A World Without Debt*, *supra* note 2, at 819, 825-27.

56. *See* Daniel L. Keating, *Offensive Uses of the Bankruptcy Stay*, 45 VAND. L. REV. 71, 122-25 (1992); DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 48-55 (2d ed. 1990). Professor David Skeel has recently identified a related problem, that of vestigialization, in another context. *See* David A. Skeel, *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

57. LoPucki & Whitford, *Corporate Governance*, *supra* note 15, at 683-84.

58. *See* Henry Hansmann & Reiner Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1884-85 (1991) (noting that many failing corporations choose

likely, corporate management may adopt a strategy of stalling pending litigation as much as possible, in order to drive down the plaintiffs' settlement offers, while operating the corporation as well as possible without adequate access to credit and hoping for a government bailout, development of a miracle cure, or other windfall. This kind of strategic behavior greatly increases the transactional costs of settling the tort claims, while the corporation's productive assets are managed in less than an optimal fashion.[59]

With respect to crippling long-term contracts, such as the situation in Revere Copper & Brass, inability to come to some kind of final resolution can provoke strategic behaviors similar to the mass tort situation. Management may simply delay negotiations for settlement of the dispute, hoping that unforeseen future events will put pressure on the other party to settle cheaply. In the meantime the corporation's access to credit markets is likely to be restricted because of its contingent liability on the long-term contract, hampering the corporation's ability to manage its productive assets optimally. Further, management may have incentives to pursue unacceptable risks, in hopes of striking it rich and increasing its ability to buy its way out of the contract.

My point here is not that a creative use of bankruptcy in each of these situations provides an optimal solution to the problems facing the company. Law review articles suggesting nonbankruptcy solutions have been written about each of the problems.[60] Furthermore, in each instance, if the bankruptcy alternative were not available, something would still happen. Our ability to predict what would happen is hindered by lack of knowledge about the effectiveness of controls on management behavior at times of corporate stress.[61] However, whatever would happen may be superior to the bankruptcy result in some cases.[62]

Despite these considerations, one certainly cannot assume on an a priori

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to liquidate before they become liable for long-run hazards).

59. *See* Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1 (1986) [hereinafter Roe, *Corporate Strategic Reaction*]; Mark J. Roe, *Bankruptcy and Mass Tort*, 84 COLUM. L. REV. 846, 856 (1984) [hereinafter Roe, *Mass Tort*] ("An early resolution of . . . large, contingent tort liability may be necessary . . . to prevent the debtor firm's . . . collapse.").

60. *See* Robert A. Hillman, *Court Adjustment of Long-Term Contracts: An Analysis Under Modern Contract Law*, 1987 DUKE L.J. 1; Victor P. Goldberg, *Price Adjustment in Long-Term Contracts*, 1985 WIS. L. REV. 527; authorities cited *supra* note 59.

61. *See* Roe, *Corporate Strategic Reaction*, *supra* note 59; *supra* notes 19-24 and accompanying text.

62. Moreover, the availability of the bankruptcy solution may retard effort on legislative development of superior nonbankruptcy solutions.

basis that we are worse off because of the availability of creative bankruptcy. Ironically, despite the great concern about delay in Chapter 11, I am reasonably certain that in today's world the creative use of bankruptcy often provides a quicker solution to a corporation's troubling circumstance than would be reached in the absence of the bankruptcy alternative. Many asbestos manufacturers who chose not to file Chapter 11 struggled for years with products liability claims, for example.[63] Because any solution is likely to resolve some of the distortions of corporate decisionmaking discussed above, quicker solutions are to be preferred absent countervailing considerations. The likelihood of a positive social utility resulting from creative uses of bankruptcy is enhanced because bankruptcy judges have sometimes asserted discretion to dismiss cases not filed in "good faith." Hopefully, judges distinguish between desirable and undesirable uses of creative bankruptcy in exercising this discretion.[64]

Discussion of the proposed alternatives to Chapter 11 has not usually focused on creative uses of Chapter 11.[65] None of the suggested alternatives seems to have the same creative potential as Chapter 11 presently has, however. One big problem with the alternatives concerns the initiation of bankruptcy. All of the alternatives have in common the probability that management will be replaced very shortly after filing (or default in case of the contingent equity proposal). For this reason, management may avoid using any of the alternatives as a way to avoid single large liabilities, preferring instead to stumble along with nonbankruptcy solutions.[66] A

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63. *See* L.A. TIMES, Dec. 10, 1990, at D2 (discussing class action litigation involving Eagle-Picher Industries). In the Johns-Manville Chapter 11 case, the trust fund that was established to compensate asbestos victims quickly became insolvent, and so the tort claimants continued to struggle to gain compensation. *See A History of Asbestos and the Manville Trust Fund*, WASH. POST, Nov. 20, 1990, D7. At least the corporate assets were not subject to claims against the trust fund, however, so the corporate governance problems that can result from insolvency were avoided. Eagle-Picher Industries avoided bankruptcy until 1991, and its Chapter 11 case is still pending.

64. My views in this respect are similar to those expressed in Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919 (1991) (arguing that Chapter 11's good faith filing requirement acts as a limit on certain tactical uses of the Code). *See also* Carlos J. Cuevas, *Good Faith and Chapter 11: Standard That Should Be Employed to Dismiss Bad Faith Chapter 11 Cases*, 60 TENN. L. REV. 525 (1993) (arguing that an "objective-subjective" test for filing is necessary to limit creative bankruptcy).

65. An exception is Adler. Adler, *A World Without Debt*, *supra* note 2, at 819, 825-27 Adler argues that the problems addressed by creative uses of bankruptcy are not just bankruptcy problems and need to be addressed generally, not just in the context of bankruptcy. In a perfect world he is obviously correct, but we do live in a second best world.

66. In the case of the contingent equity proposal, avoiding use of the alternative means avoiding default, which triggers the conversion of debt to equity. Management can avoid default by engaging

similar incentive to avoid bankruptcy already exists, because as mentioned above, replacement of existing management is a common event in Chapter 11.[67] Such replacement is probably less common, however, when Chapter 11 is being used "creatively."

Chapter 11's creative potential largely depends on features of Chapter 11 that would be rescinded by the alternative proposals. For example, Texaco's ability to negotiate a favorable settlement of the Pennzoil judgment was enhanced by the automatic stay, which prevented any coercive collection activities by Pennzoil,[68] coupled with Texaco's ability to control the pace of the bankruptcy so long as it retained the exclusive authority to propose a plan.[69] The ability to delay the proceeding while not making payments on existing indebtedness may also have contributed to Revere's ability to negotiate a favorable settlement with ALCOA. All of the alternative proposals have in common cessation of the debtor's ability to delay the proceeding indefinitely. I have argued elsewhere that delay is a major problem in Chapter 11 and measures to address it are needed.[70] But if one concludes that the creative use of Chapter 11 reached desirable results in Texaco and Revere,[71] Chapter 11's flexibility

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in various types of less-than-optimal corporate behavior—e.g., by selling assets to raise cash for debt payments, or by borrowing new amounts on unfavorable terms for repayment of debt.

67. *See supra* note 15 and accompanying text. For an insightful discussion of the problem of bankruptcy in the mass tort context, see Roe, *Mass Tort*, *supra* note 59, at 905-17.

68. Just before Texaco filed Chapter 11, Pennzoil threatened to file judgment liens against all of Texaco's real estate in Texas. This action would have triggered default covenants in all kinds of extant Texaco indebtedness, accelerating great amounts of future indebtedness and perhaps causing Texaco to liquidate large quantities of assets to repay this debt. By filing bankruptcy, Texaco prevented Pennzoil from credibly threatening to use this tactic, and by doing so greatly weakened Pennzoil's bargaining leverage.

69. Texaco increased its settlement offer by about $1 billion immediately after the bankruptcy judge implied a willingness to remove exclusivity.

70. LoPucki & Whitford, *Corporate Governance*, *supra* note 15, at 787-88.

71. In the case of Texaco, my concern is with the fairness of the underlying judgment in favor of Pennzoil. I share the widely held belief that this judgment was a travesty of justice. While reversal of the judgment by the Texas appellate courts would have been a much neater solution, and maybe even overturning of the verdict by the federal courts on some ground would have been better, bankruptcy at least contributed to a more appropriate settlement. Perhaps it was the best practically available solution. On the other hand, enforcement of the Texas judgment may have generated political demands for reforms that would have prevented such travesties from occurring again. As always, the most efficient path to social justice is uncertain.

With Revere, the issue is whether a party to a long-term contract should ever receive relief because of changes in market conditions that were not fully anticipated. Several respected commentators believe that contractual relief is sometimes appropriate in such circumstances. *See* authorities cited *supra* note 60. I do not know whether Revere presented a situation in which these commentators would favor relief, but if it did, perhaps bankruptcy provided an easier and less costly avenue to that relief than with respect to such matters as the debtor's exclusive authority to propose a plan can be seen to have positive social utility.

C. *Preserving Community*

Various commentators have emphasized preservation of community values as a goal or possible desirable effect of Chapter 11.[72] There is social value, I believe, in preserving institutions as ongoing entities, including established businesses.[73] There is nothing in the alternative proposals that forecloses that result, however. In an immediate auction, a business (or set of businesses) can be sold as a unit to a buyer that will continue to operate it as such. And under the contingent equity proposal, there need not be a sale of the business or a change in the corporate entity at all; there could be only a change in the ownership of the shares.

Nonetheless, the flexibility of Chapter 11, including the ability to use it creatively, can contribute to preservation of an ongoing business in particular circumstances. The Phoenix Steel case, one of the cases Professor LoPucki and I studied intensively, provides an instructive example.

Phoenix Steel (Phoenix) was a small steel manufacturer that operated two mills, one in Pennsylvania and one in Delaware. It joined the rush of steel companies filing Chapter 11 petitions in 1983. It immediately renounced its pension obligations, making the Pension Benefits Guarantee Corporation (PGBC) its largest unsecured creditor. Its majority shareholder at the time was a French steel company that was embroiled in its own insolvency proceeding in France.

From the beginning of the bankruptcy proceedings, Phoenix's board of directors took a very active role in formulating reorganization strategy. The

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protracted contract litigation.

72. *See, e.g.*, Karen Gross, *The Need to Take Community Interests Into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994).

73. *See* LoPucki & Whitford, *Patterns*, *supra* note 36, at 603-04. *See also* Warren, *supra* note 5, at 354-55. Professor Warren makes the following observation:

> Bankruptcy policy also takes into account the distributional impact of a business failure on parties who are not creditors and who have no formal legal rights to the assets of the business. Business closings affect employees who will lose jobs, taxing authorities that will lose ratable property, suppliers that will lose customers, nearby property owners who will lose beneficial neighbors, and current customers who must go elsewhere. Congress was acutely aware of the wider effect of a business failure on the surrounding community, and it adopted the 1978 Bankruptcy Code specifically to ameliorate those harmful effects—that is, to redistribute the benefits that would stem from some creditors' collection rights to other parties who did not enjoy those rights.

Warren, *supra* note 5, at 354-55.

Board reached an agreement with the French parent for the reciprocal waiver of all claims, as creditor or shareholder, in the bankruptcy proceedings of each. This agreement left the Board with no accountability to the principal that had controlled its appointment. Thereafter, the primary goal of the Board was to keep the mills operating.

The company rejected a collective bargaining contract, unilaterally imposed a lower wage structure, and later renegotiated a new, more favorable collective bargaining agreement. It then looked for a buyer or for new investors. An investment banker hired for this purpose was unable to find a buyer. Meanwhile, the provider of the company's working capital loan, BancAmerica, was unwilling to renew the financing without additional collateral, which the Company could not provide. At this dark moment, an investment group approached the Company. After first negotiating an acceptable reorganization plan with the major creditors' interests, this group persuaded BancAmerica to renew the working capital loan in return for independent guarantees provided by the group. The investors also made some additional loans to the company and in return received all of the shares in the reorganized company.

The reorganization plan that was confirmed stretched out the payment dates under publicly held industrial bonds, even though the bondholders would probably have fared well if they had foreclosed on their real estate collateral. Most of the rest of the creditors received notes or preferred shares. Trade creditors received only preferred shares, but supported the plan nonetheless because it kept the mills open and thus preserved a major customer.

After confirmation the company continued to falter. It refiled Chapter 11 only two years later. In the second bankruptcy the two mills were sold, each to a separate company. The buyers assumed the obligations under the industrial bonds and kept the mills running, but the company received very little for the plants and holders of notes and preferred shares issued under the first plan of reorganization received basically nothing.

In many ways Phoenix Steel looks like Eastern Airlines. Early liquidation was avoided in hopes of preserving the company, though the company continued to incur operating losses. In the end, however, the plants remained open and jobs were preserved.[74] Whether these benefits

74. Jobs were preserved at least for a while. One of the successor companies refiled in Chapter 11 (the third filing in this convoluted matter) after the market deteriorated dramatically for its specialized steel product.

The other company, owned by the Chinese government, is still operating. However, since its are sufficient to justify the additional losses to creditors that probably resulted is difficult to know. None of the creditor groups pushed strongly for liquidation early in the proceedings, but perhaps that was partly a result of the difficulty of forcing liquidation under Chapter 11 when management is strongly committed to keeping the company operating. It is probably true that Phoenix avoided piecemeal liquidation only because of the special powers of Chapter 11.[75] As mentioned above, extensive efforts early in the first reorganization to find a buyer that would operate the mills were unsuccessful; an immediate auction would probably have led to piecemeal liquidation.

IV. CONGRESSIONAL FAILURE: CHAPTER 11 AS DELEGATION

Chapter 11 grants a great deal of discretion to the judiciary. For example, a debtor's ability to deliberately delay a proceeding is often dependent on maintenance of exclusive authority to propose a plan, but a bankruptcy judge has authority to terminate exclusivity at any time.[76] An auction of assets is possible within Chapter 11, subject to the judge's approval.[77] While a judge does not have any explicit authority to initiate an auction, the power to appoint a trustee[78] is probably sufficient to enable a judge to induce an auction in any circumstance in which the judge and at least one claimant favor such action.[79]

Using this extensive discretion, bankruptcy judges could prompt change in contemporary bankruptcy practices that would address much of the criticism of Chapter 11. There are difficulties, however, with relying on

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acquisition of the steel mill, the new owner has been involved in extensive political difficulties in Delaware. The mill had actually been closed by Phoenix Steel during the second reorganization. The plant was reopened after its acquisition, but the new owner refused to rehire many of the former employees, substituting cheaper labor instead. Legislation designed to force the new company (called CitiSteel) to rehire the former employees was vetoed by the Delaware governor.

75. Among these was the power to reject pension obligations and collective bargaining contracts, which allowed the company to reduce its operating costs substantially.

76. 11 U.S.C. § 1121(b), (d) (1988).

77. 11 U.S.C. § 363(b) (1988).

78. 11 U.S.C. § 1104(a) (1988).

79. The judge can appoint a trustee only upon a motion filed by a party in interest or the United States Trustee. *Id.*

Another reform possible by the exercise of judicial discretion within the present statutory structure is preemptive cramdown. A preemptive cramdown is an order early in the proceeding that a group of junior interests—most likely, shareholders—is so unlikely to be entitled to a distribution at confirmation that it will not be treated as a party in interest during the case. The purpose is to prevent such underwater interests from negotiating for a nuisance value distribution in the final reorganization plan. *See* Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANK. L.J. 625 (1991).

the bankruptcy courts to be the vehicle for bankruptcy reform. Most importantly, there is no assurance that bankruptcy judges will use existing discretion to move bankruptcy law in desirable directions. Professor LoPucki and I have written previously about the incentives for bankruptcy judges to exercise their discretion in ways that favor management interests, in order to attract large Chapter 11 cases to their districts.[80] Value choices are also at stake in the debate about bankruptcy reform—for example, with respect to the degree to which an insolvency reorganization should be conducted to preserve community, as advocated by some commentators. Democratic theory implies that value choices such as these should be made by Congress, not by an unelected judiciary.

There is increasing recognition of the ways in which Congressional processes fail to fulfill democratic ideals. With respect to bankruptcy legislation, considerable emphasis has been given recently to concerns that concentrated and organized interests will tend to win their way in Congress.[81] In my view, an even more fundamental problem with Congress is the tremendous incentives it has simply to do nothing. To an individual member of Congress, taking a stand means disappointing some group of constituents, and perhaps losing their votes, whereas avoidance of an issue allows each member to attribute responsibility for Congress's failure to solve a problem to somebody else.[82] This desire to avoid controversial issues is one reason it has taken so long to enact the currently pending bankruptcy reform legislation, including the proposal to establish a new Bankruptcy Review Commission.[83]

These concerns, drawn from public choice theory, are very real. Equally

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80. 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. One district widely reputed to have responded to such incentives is the Southern District of New York. *See* Mark Dickstein, *Macy's Debtor Paradise*, WALL ST. J., Jan. 19, 1994, at A18 ("One reason the Macy's bankruptcy has not been handled this way [repeated extensions of exclusivity] is that it is being heard in the Southern District of New York, a location that has sometimes been referred to as 'Debtor's Paradise.'").

81. *E.g.*, Adler, *Financial and Political Theories*, *supra* note 2, at 341-46.

82. *See* William N. Eskridge, Jr., *Politics Without Romance: Implications of Public Choice Theory for Statutory Interpretation*, 74 VA. L. REV. 275, 288 (1988).

83. Bankruptcy Reform Act of 1994, H.R. 5116, 103d Cong., 2d Sess. (1994). At the time of this writing, this legislation had not been signed by the President. It took more than four years for proponents of this legislation to get it enacted, and even then, until the very end of the 103rd Congress, it was not expected to pass. *See Congress Finally Passes Bankruptcy Reform Legislation*, BANKR. L. DAILY (BNA), Oct. 11, 1994, at 1007-08 ("Speculation that Congress would adjourn without taking action on bankruptcy reform, as it had during the 102nd Congress in 1992, ended late Oct. 6 [1994] when the Senate passed by voice vote the Bankruptcy Reform Act of 1994 (H.R. 5116).").

troublesome to my mind, however, is the cumbersome Congressional procedure that makes it difficult for Congress to make a great number of policy decisions in any one year or biennium. Furthermore, each member of Congress has so much to do that it is hard to direct his or her attention to very many issues at one time. Consequently, as is well known, when bankruptcy legislation is considered, there tend to be only a few members of Congress with any real expertise, and they are likely to have great influence on all but the most basic policy decisions. These members often come from politically safe districts, insulating them from the most evident kind of democratic accountability. As the congressional process in fact operates, it is difficult to justify much bankruptcy legislation as reflecting a "democratic" choice—i.e., one reflecting a majoritarian will.

Congress' difficulties in legislating raise additional concerns about the proposed radical reforms of Chapter 11. Those reforms all require major legislation that would either reduce bankruptcy court discretion or eliminate bankruptcy courts entirely. If unforeseen problems develop in the administration of a new scheme, it might not be possible to correct the problems without additional congressional legislation. That amendatory legislation might not come quickly.[84] And because Chapter 11 has served so many varied purposes, as I have argued in this paper, the risk is high that comprehensive reform will fail to provide an adequate replacement for some present use of Chapter 11.

The wiser and more practical path to reform may be to persuade bankruptcy courts to use their considerable discretion. The incentives that now exist for bankruptcy courts to use their delegated power in the interests of incumbent management[85] do not necessarily create insurmountable barriers to a wiser use of that power. Through education and persuasion, along with social pressure resulting from the emerging academic consensus that some reforms are needed, some judges can be convinced to do the right thing. Appellate judges may be able to force the hands of recalcitrant judges. The Bankruptcy Rules process is another vehicle for reform within the existing statutory structure. And most importantly, if experience shows

84. One is reminded of how long it took Congress to act after the constitutional authority of bankruptcy courts was drawn into question by the Supreme Court in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982) (holding that bankruptcy judges could not hear claims "related to" bankruptcy proceedings). *See* 28 U.S.C. § 157(c) (1984) (addressing the *Northern Pipeline* holding by mandating that such decisions on "non-core" proceedings be entered by the district court judge after a review of the bankruptcy judge's proposed findings).

85. *See supra* note 80 and accompanying text.

that mistakes have been made as bankruptcy courts experiment with new ways of doing things, correction is likely to come more quickly.

V. SUMMARY

Consideration of proposals to replace Chapter 11 with other schemes for resolving the debt problems of insolvent corporations requires comparison of imperfect alternatives. The comparison is difficult because, although Chapter 11 has been extensively tested, the proposed alternatives are necessarily untested. The purpose of this article has been to contribute to this difficult comparison by highlighting some less commonly recognized features of Chapter 11, as it is applied in the bankruptcy reorganization of publicly held corporations.

I began by setting the record straight with respect to some of the deficiencies commonly attributed to Chapter 11. First, while the direct costs of bankruptcy reorganization are substantial, they are not nearly as high as is commonly reported. Second, deviations from the absolute priority rule in reorganization plans, though common, are typically so small as not to be a serious source of inefficiency in Chapter 11. Third, for sound theoretical reasons, when a corporation becomes insolvent, management should no longer be devoted exclusively to the enhancement of shareholder interests; and contrary to the assumptions of many, in Chapter 11 it usually is not. Nor is there a sound empirical basis for the common assumption that in Chapter 11 management is able to run the corporation opportunistically to serve its own interests.

There are many anecdotes told about unsuccessful Chapter 11 reorganizations, such as Eastern Airlines. I have related the circumstances of three cases whose results were viewed as highly successful by most of the participants. These countervailing anecdotes point to the most basic truth about Chapter 11—it is a highly flexible procedure capable of many different uses, and results under it vary widely. I have generalized about these varying uses by identifying three goals of a Chapter 11 proceeding other than reorganization of widely held debt. One goal is controlled liquidation, i.e., liquidation over time in a piecemeal fashion. There is reason to believe that in many circumstances controlled liquidation will yield a higher return for creditors than immediate liquidation, and that it is best conducted within Chapter 11. A second goal is dealing with a single large liability (or set of related liabilities) which is crippling the debtor. I have used the term "creative bankruptcy" to describe this use of Chapter 11 and suggested reasons why, in this imperfect world, creative bankruptcy may be superior to the practically available alternatives. A third goal is preservation of existing institutions (such as manufacturing plants) as ongoing entities, sometimes referred to as the preservation of communities.

A final virtue of Chapter 11 is its malleability. Congress has granted bankruptcy judges a great deal of discretion in the administration of Chapter 11 proceedings, so much that Chapter 11 can be seen as a form of legislative delegation. This delegated power has not always been used wisely, but it could be used more wisely in the future. There are serious inadequacies with respect to how Congress approaches bankruptcy legislation. Too often Congress does nothing, because legislative inaction is in the self-interest of most of its members. Consequently, an additional advantage to Chapter 11 is that it permits courts to make important changes in bankruptcy practice without the need for further legislation.