

COMPENSATING UNSECURED CREDITORS FOR EXTRAORDINARY BANKRUPTCY REORGANIZATION RISKS

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In a series of articles, we reported the results of an empirical study of the bankruptcy reorganization of large, publicly held companies during the 1980s.¹ One of our findings was that the managements of reorganizing companies often did not pursue optimal investment policies during reorganization. Instead, they tended to act as caretakers responsible for preserving the company until the reorganization was concluded. They avoided substantial asset sales when possible and rarely made substantial acquisitions or other new investments. We referred to this practice as “prudent investment.”

In an article published last year, we advocated abandonment of the prudent investment practice in favor of a policy of maximization of the value of the bankruptcy estate.² We attributed management’s failure to

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1. Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597 (1993); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*]; 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 [hereinafter LoPucki & Whitford, *Venue Choice*]; 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) [hereinafter LoPucki & Whitford, *Bargaining Over Equity’s Share*]; see also Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625 (1991) [hereinafter LoPucki & Whitford, *Preemptive Cram Down*] (advocating the extinguishing of shareholder interests in some cases of insolvent debtors).

2. LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 787 (“[W]e suggest that attempting to maximize the value of chapter 11 estates offers the best possibility for minimizing deadweight losses.”). See also Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors*, 46 VAND. L. REV. 1485 (1993) (advocating the same position). Under current law it may already be management’s duty to maximize the value of the Chapter 11 estate, but judicial statements on this issue are rare. *E.g.*, *Wabash Valley Power Ass’n, Inc. v. Rural Electrification Admin.*, 903 F.2d 445, 451 (7th Cir. 1990) (“A debtor [in possession] in bankruptcy is supposed to maximize the value of the estate . . .”).

follow a policy of maximization to difficulties presented by the conflicting interests of creditors and shareholders.³ To reduce creditors' and shareholders' incentives to resist managers' efforts to maximize, we proposed that parties to the reorganization case who stand to benefit during the pendency of a Chapter 11 reorganization from a particular investment be required to compensate those disadvantaged by it.⁴ The purpose of this article is to elaborate on that proposal.

I. THE CONFLICT BETWEEN CREDITORS AND SHAREHOLDERS OVER INVESTMENT POLICY

Finance theory has long recognized the potential for conflict between creditors and shareholders over the investment policy of the firm.⁵ Fama and Miller employ an illustration⁶ in which a firm in period 1 has promised payment of 5 to its bondholders in period 2. The firm must choose between zero-risk production plan a, which will assure that the firm has a value of 7 in period 2, and high-risk production plan b, which creates equally likely possibilities that the firm will have a value of 1 or 10 in period 2. Plan a is in the interests of the bondholders; its adoption will insure their payment in full. Plan b offers bondholders no possibility of more than full payment and threatens them with the possibility of less. Under one possible state in period 2, the firm will have value of only 1 and therefore be unable to pay the 5 it owes bondholders. Plan b is in the interests of the shareholders; its adoption gives the shareholders a 50% probability that there will be no value for them in period 2 and a 50% probability that a value of 5 will be available to them in period 2. The expectancy value of the shareholders' recoveries is 2.5, higher than the value of 2 they would receive under plan a. The following table is reproduced from Fama and Miller's book:⁷

3. LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 782-85.

4. *Id.* at 788-92.

5. *See, e.g.*, EUGENE F. FAMA & MERTON H. MILLER, *THE THEORY OF FINANCE* 178-81 (1972).

6. *Id.* at 179-80.

7. *Id.* at 180. In Table 1, V(1) is the value of the company at period 1, B(1) is the value of the bonds at period 1, and S(1) is the value of the shares at period 1.

TABLE 1

Production Plan	Payoff at Period 2		Market Values at Period 1		
	State 1	State 2	V(1)	B(1)	S(1)
a	7	7	7	5	2
b	1	10	5.5	3	2.5

NOTE: $p(1) = p(2) = 0.5$. Promised payment on debt is 5 at period 2.

In Fama and Miller's illustration, plan a is in the interests of the bondholders, and it also maximizes the present value of the firm. But Fama and Miller presumed that the shareholders would control investment policy and that the company would pursue plan b.

Fama and Miller considered their observation of little practical importance for two reasons. First, they did not think such situations often arose.⁸ Second, when such situations did arise, they thought the parties could solve the problem by agreement. That is, the party that stands to benefit from an optimal investment policy could pay the party in control to pursue that policy. For example, if the bondholders in the Fama and Miller illustration offer shareholders more than 0.5 of the bondholders' recovery to pursue plan a, it then will be in the interests of bondholders, shareholders, and the firm to pursue it.⁹ In the words of Fama and Miller:

[T]here may be some way, and indeed there may be many ways, that side payments between the bondholders and shareholders can be arranged so that with the operating decision that maximizes [firm value] every security holder's wealth is at least as great as it would be with any other operating decision.¹⁰

For this reason, Fama and Miller did not develop further the implications of the conflict they had identified.

Fama and Miller were concerned principally with solvent companies

8. FAMA & MILLER, *supra* note 5, at 180.

From a practical viewpoint, however, situations of potential conflict between bondholders and shareholders [regarding investment policy is] probably unimportant. In general, investment opportunities that increase a firm's market value by more than their cost both increase the value of the firm's shares and strengthen the firm's future ability to meet its current bond commitments.

Id.

9. *Id.* at 179.

10. *Id.*

operating in the absence of bankruptcy. Their first assumption, that the conflict between bondholders and shareholders seldom actually arises, is not true for insolvent companies. One of us has explained at length the variety of conflicts between creditors and shareholders that actually arise in insolvency and in bankruptcy.¹¹ Moreover, in our study of the bankruptcy reorganization of large, publicly held companies during the 1980s, we found empirical evidence of creditor-shareholder conflict with regard to investment policy during the pendency of the proceeding.¹²

Fama and Miller's second assumption, that shareholders and bondholders can realign their interests through side deals, also appears to be untrue for companies once they enter bankruptcy reorganization. We found in our study that such deals regarding investment policy were made only as part of a plan of reorganization that resolved the entire case.¹³ Parties such as shareholders and bondholders did not, at least openly, reach interim deals giving one party the investment policy it preferred on the condition that it compensate the other parties. Because we did not empirically investigate the reasons the parties did not make such deals, we can only speculate as to what those reasons were. Perhaps all the parties were unable to reach agreement.¹⁴ But such deals might have been regarded as improper. The managers of companies in reorganization are regarded as officers of the court, bound to manage for the benefit of all interested parties. For the principal parties to the case to strike an agreement that required management to adopt a particular investment policy and also provided that one of the principal parties would compensate another might be construed as the payment of money for acting or forbearing to act in a bankruptcy case, which is a criminal offense.¹⁵

11. Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wis. L. REV. 311, 333-43.

12. LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 672 (examining the Continental Airlines and Manville Corporation reorganization cases).

13. *Id.* at 790.

14. Bankruptcy courts, like other kinds of courts, are usually amenable to a course of action that has been agreed to by all parties. But an agreement of the nature described here, though it might draw no objection, would seldom be agreed to by everyone. There may be other interests whose representatives have not joined in the agreement or there may be conflicts of interest between the representatives who have agreed to the deal and the constituents on whose behalf they have agreed.

15. 18 U.S.C. § 152 (1988) ("Whoever knowingly and fraudulently gives, offers, receives or attempts to obtain any money or property . . . for acting or forbearing to act in any [bankruptcy] case . . . [s]hall be fined not more than \$5,000 or imprisoned not more than five years, or both."). We do not advocate that this provision be interpreted as prohibiting the kind of creditor-shareholder transfers that Fama and Miller presupposed. So long as the transfers are not secret, they should not be regarded

II. ACCOMMODATING CREDITOR-SHAREHOLDER CONFLICT THROUGH PRUDENT INVESTMENT

In this Part we describe why, under current practice, investment policy during a reorganization proceeding tends to follow the pattern we describe as prudent investment. The bankruptcy reorganization system formally provides for investment policy through a grant to management of ostensibly broad discretion. Upon the filing of a bankruptcy reorganization case, the debtor becomes debtor in possession and its management continues in office. The debtor in possession is generally authorized to continue to operate the business in the ordinary course.¹⁶ For transactions outside the ordinary course of business, management must obtain court approval after notice and a hearing.¹⁷ In granting approval, the courts extend deference to the expertise of management in a manner similar to that extended by state courts to management under the business judgment rule.¹⁸ The managers owe fiduciary duties to the corporation, its creditors, and its shareholders, but in bankruptcy there has been almost no litigation concerning how these duties affect investment policy.¹⁹ There is little evidence that concerns about fiduciary obligations have had any practical impact on investment policy in bankruptcy.

To understand why a formal grant of discretion to management results in a prudent investment norm, one must first understand how a management's attempt to effect even a small increase in firm value can result in a dramatically large shift in the entitlements of creditors and shareholders. Assume that the debtor owes unsecured creditors \$100 million and that its sole asset is a chain of restaurants with an estimated liquidation value of \$100 million. Management is considering an investment plan under which it would borrow \$100 million secured by the restaurants and invest it in a new restaurant format; that is, the money would be spent in giving the restaurants a new image and appearance. If the new format is successful, management believes that the value of the company will be \$240 million over and above what will then be owing to secured creditors; if the new format fails, management believes the

as "fraudulent." Indeed, we advocate in this article a procedure to encourage and in some cases mandate such transfers.

16. 11 U.S.C. §§ 1107(a), 1108, 363(c)(1) (1988).

17. 11 U.S.C. §§ 363(b)(1), 364(b) (1988).

18. LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 705.

19. *See id.* at 706-10.

restaurants will have no value over and above what is owing to secured creditors—the secured creditors will repossess everything. Management considers the two outcomes equally likely. Further assume that the market values of the expectancies thus generated are as shown in this table:²⁰

TABLE 2
VALUE OF EXPECTANCIES FOR FIRM

	Level of risk	Total return	Value of expectancies before risk discount	Market value
Liquidate	0%	\$100 million	\$100 million	\$100 million
Reopen	50%	\$240 million or \$0	\$120 million ^a	\$105 million ^b

a. This number is simply a weighted average of the possible results indicated in the previous column. Since each outcome has a 50% probability, the expectancy is the average of the two.

b. We have assumed a risk discount rate of 12.5%. This assumption is arbitrary and is not based on actual market discount rates or estimates thereof.

To maximize the value of this company, management should pursue the high-risk investment policy. Yet the risk of pursuing that policy would be borne entirely by the unsecured creditors. As soon as the debtor committed to that course of action, the value of the unsecured creditors' expectancy would fall to less than half of what the unsecured creditors would have received in liquidation:

TABLE 3
VALUE OF EXPECTANCIES FOR CREDITORS

	Level of risk	Creditors' return	Value of creditors' expectancy before risk discount	Market value of creditors' expectancy
Liquidate	0%	\$100 million	\$100 million	\$100 million
Reopen	50%	\$100 million or \$0	\$50 million	\$43.75 million

20. Tables 2, 3, and 4, including the associated footnotes, are reproduced from LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 783-84.

The new course would benefit shareholders even more than it would injure creditors:

TABLE 4
VALUE OF EXPECTANCIES FOR SHAREHOLDERS

	Level of risk	Shareholders' return	Value of shareholders' expectancy before risk discount	Market value of shareholders' expectancy
Liquidate	0%	\$0	\$0	\$0
Reopen	50%	\$140 million ^a or \$0	\$70 million	\$61.25 million

a. This figure assumes that the reopening was successful and that the restaurant chain increased in value to \$240 million. If a reorganization plan was then confirmed and securities having this value were distributed, the first \$100 million in securities would be distributed to creditors under the absolute priority rule, leaving securities worth \$140 million for shareholders.

Were management truly independent of the creditors and shareholders, the potential for their investment decisions to redistribute wealth between creditors and shareholders would not be troublesome. In fact, however, reorganization management is independent only in a formal sense. As we have described in greater detail elsewhere, the system of corporate governance during bankruptcy reorganization is an elaborate game of capture.²¹ In this game, management is a semi-autonomous player whose leverage derives from its powers of initiative with regard to transactions during the pendency of the reorganization and to a reorganization plan, its influence over the timing of the reorganization case, its superior access to information, and other factors.

Contrary to the assumptions underlying most models of corporate governance during reorganization,²² shareholder democracy largely ceases to function during bankruptcy reorganization. We found that if the company was insolvent, shareholders had little ability to discipline

21. *Id.* at 692-720.

22. A catalog of models employing unrealistic assumptions about the relationship between shareholders and management during bankruptcy appears in LoPucki and Whitford, *Corporate Governance*, *supra* note 1, at 673 n.8.

management by threatening to vote them out of office.²³ The bankruptcy courts were likely to enjoin the vote. If the company was solvent, the courts were more likely to permit shareholders to vote, but even then were not certain to do so. Creditors had similarly little ability to remove managers from office through formally recognized legal means. Creditors do not vote on the continuation of management in office. While creditors can move for the appointment of a trustee, such motions are rarely made or granted.²⁴

We found, however, that both creditors and shareholders had considerably greater power to remove or discipline managers informally. For example, creditors often had the ability to extend or withhold needed credit.²⁵ Creditors and shareholders could generate leverage against management by objecting to or threatening to object to actions management wished to pursue. Groups of creditors or shareholders could also gain leverage over management by participating in the fixing of management employment contract incentives.

In practice, this combination of leverages tended to produce behavior reflecting a policy of prudent investment—a convenient compromise of competing interests. Management's reluctance to take new initiatives protects creditors from the risk of large additional losses. At the same time, continuation of the existing businesses preserves the jobs of management and offers junior interests some hope that changing market conditions will cause a sufficient increase in the value of those assets that the reorganization plan can provide for a distribution to them. But the failure of the practice of prudent investment is that it is not calculated to maximize the value of the firm's assets. If it does so, it is sheer coincidence.

III. RESOLVING CREDITOR-SHAREHOLDER CONFLICT THROUGH COLLAPSED RESIDUAL OWNERSHIP

In an article published in 1988,²⁶ Professors Douglas G. Baird and Thomas H. Jackson proposed to resolve the creditor-shareholder conflict by vesting the power to govern the reorganizing company in the "residual claimants." As they put it:

23. *See id.* at 696-98.

24. *See id.* at 699-700.

25. *See id.* at 701-04.

26. Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988).

The Bankruptcy Code pays too little attention to ensuring that the residual claimants are in control of the firm. . . . [T]he law of corporate reorganizations should focus on identifying the residual owner, limiting agency problems in representing the residual owner, and making sure that the residual owner has control over the negotiations that the firm must make while it is restructuring.²⁷

Baird and Jackson recognized that a reorganizing firm might have a range of possible future values, making it difficult to identify the residual owners who “should always be the ones who enjoy the benefits of making good decisions and incur the costs of making bad ones.”²⁸ That is, depending on how various risks played out in the future of the business, a company might be either solvent or insolvent. Baird and Jackson proposed to resolve the difficulty by “collapsing” the future possibilities of various values to a single present value, in much the same way that a purchaser of the company would when deciding how much to pay.²⁹ That is, the present value of the company is the average of the possible future outcomes, each weighted by the likelihood it will occur. They justified this approach on the basis that the reorganizing company is in default; to collapse all future possible values into a single current “price” is to give the creditors only what they are entitled to under their contracts.³⁰

We criticized Baird and Jackson’s collapsed residual ownership proposal because, in the context of a reorganization case, it would not accomplish its purpose of putting control in the hands of those who stood to gain or lose by the investment decision. Rather than eliminating the conflict, granting control to the collapsed residual owner would merely enable the collapsed residual owner to resolve the conflict in its own favor. In some cases, the collapsed residual owner would accomplish this by pursuing a suboptimal investment policy. To illustrate our point, assume that the company hypothesized by Fama and Miller is in bankruptcy reorganization during period 1. Although the decision the company is about to make may render it insolvent, the shareholders are currently the collapsed residual owners.³¹ They presumably would choose production plan b because it

27. *Id.* at 765, 775.

28. *Id.* at 787-88.

29. *Id.* at 755.

30. *Id.* at 762.

31. The firm owes 5 to creditors, which is less than its present value in period 1 regardless of which investment plan it chooses.

would maximize the value of their interest³² even though that plan does not maximize the value of the company.³³ Thus, on the facts of Fama and Miller's example, collapsed residual ownership would lead to adoption of the wrong plan.

For collapsed residual ownership to work, the collapsing cannot be merely theoretical, it must be real. Once the reorganization system determines the identity of the collapsed residual owners and gives them decisionmaking authority, it must insure that those owners bear the entire risk and reap the entire gain from the decisions they make. To insure that the residual owners and decisionmakers bear the entire risk, the reorganization system must immediately extinguish claims and interests junior to those of the collapsed residual owners, and assure absolutely the payment of claims senior to those of the collapsed residual owners.

Normally, extinction of junior claims and interests, and assurance of payment of senior claims, happens through the confirmation of a plan of reorganization at the conclusion of the bankruptcy case. That is, unless the class of which they are a member consents to lesser treatment, senior claimants will either be left "unimpaired," meaning that the senior claimants receive full "legal, equitable, and contractual rights,"³⁴ or a plan will be crammed down against them.³⁵ In a cram down, senior claimants will be entitled to property that has a present value equal to the full amount of their claim.³⁶ Therefore, unless a class senior to the residual class waives their rights, they must be assured payment in full. Unless the class deemed to be the residual owner at the time of confirmation waives its rights, all claims and interests junior to that class must be extinguished without compensation.³⁷ Indeed, a principal purpose of reorganization is to extinguish underwater claims and interests.

The hope that this restructuring can be accomplished at the beginning of the reorganization case to provide a means of determining who should control the company during reorganization is unrealistic. As the system currently operates, such restructuring is the subject of extensive negotiation and/or litigation. Once terms for the restructuring are determined and

32. The shareholders would receive 2.5 under plan b, but only 2 under plan a. *See supra* notes 6-7 and accompanying text.

33. The value of the company would be 7 under production plan a, but only 5.5 under production plan b.

34. 11 U.S.C. § 1124 (1988).

35. 11 U.S.C. § 1129(a)(8) (1988).

36. *See* 11 U.S.C. § 1129(b)(2)(A)-(B) (1988).

37. 11 U.S.C. § 1129(b)(2)(B)(ii), (C)(ii) (1988).

formalized in a confirmed plan, the case is over. Suppose that under some other procedure it was possible to determine the terms for restructuring more quickly.³⁸ There would be no reason not to use those terms to resolve the entire reorganization case. Bankruptcy reorganization would be a shorter process. While the problem of conflict between creditors and shareholders over investment policy would persist during the pendency of the shorter cases, it would be a less serious problem because it would distort the company's investment policy over a shorter period of time.

We stress that the problem of conflict between creditors and shareholders over investment policy during bankruptcy reorganization cannot be resolved until there is resolution of the entire case. An attempt to identify a residual class of claimants early in the proceeding and to put them in charge will only substitute one set of distorted investment incentives for another. That will happen because the value of the company could change over the course of the reorganization, and with it, the values of the interests of both the residual and the nonresidual claimants. The class in charge will have incentives to favor investment policy likely to increase their own share, not the value of the company. Thus, if the class in charge is a senior class, they will bear all the loss when company value declines but only some of the benefit when company value increases. If increases were great enough, they would be shared with junior classes who would then be "in the money." Hence, this senior class would continue to have an incentive to favor risk-averse investment policies. On the other hand, if the class deemed to be the "collapsed residual owner" was a junior class just barely in the money, it might bear only a small part of the cost of declines in value while reaping all or most of the benefit of increases in value. Hence, it would have incentives to favor risky investments.

In the next Part, we describe our proposal for moderating the harm resulting from the current conflict over investment policy. The essence of our proposal is to moderate the incentives for holders of senior and junior interests to compete for control of the company's investment policy. Without the pressures generated by this competition, managers could be given greater freedom to pursue the investment policy that would in their opinion maximize the value of the estate.

38. We have proposed the entry of preemptive cram down orders that would eliminate some junior claims and interests when that can be done without the need to resolve close issues of valuation. See LoPucki & Whitford, *Preemptive Cram Down*, *supra* note 1. Our purpose is to simplify the negotiations leading to the ultimate plan of reorganization, but there is a great difference between extinguishing some clearly underwater claims and interests and resolving the entire reorganization case.

IV. OUR SOLUTION: SPEEDIER REORGANIZATIONS, OPTIMAL INVESTMENT, AND RISK COMPENSATION PAYMENTS

The solution we propose to the creditor-shareholder conflict over investment policy is in two parts. The first is to minimize the length of time debtor companies remain in reorganization. As we stated above, the less time a company is in reorganization, the less opportunity there is for the conflict over investment policies to cause serious loss in company value. One of us has elaborated on this point elsewhere.³⁹

The second part of the solution we propose is more novel. First, we would have the Code explicitly mandate that the management of a Chapter 11 debtor adopt the investment policy that maximizes company value, regardless of its distributional effects. While many believe this to be the guiding rule already, it is not explicitly stated in the Code, and as we have observed, it is not the prevailing practice.

Second, we would require that the parties whose claims or interests gain value compensate the parties whose claims or interests lose value as a consequence of management's decision to vary the company's investment risk from what we have called a prudent investment strategy. The compensation we propose, which we call risk compensation payments, would not be paid in cash, but in whatever kinds of securities or rights that the parties benefitting from the investment decision have in the debtor corporation. To illustrate, consider again the case of the borderline-solvent restaurant chain that could either liquidate or gamble all of its resources on a new restaurant format. Once management decides that the expectancies generated by taking the gamble have a higher market value than the expectancies generated by liquidation or any other business strategy, management must take the gamble. The shareholders become obligated to make payments to the creditors to compensate for the extraordinary risks thereby imposed on the creditors. The payments would be in shares.

To determine the amount of compensation that shareholders must pay, one must first determine what creditors have "lost." After all, management has only acted to maximize firm value. One could argue that creditors assumed that risk when they extended credit. Based on our study, we argue to the contrary. Under current practice, the creditors should have expected, and if they thought about it probably did expect, that in the event of reorganization the company would follow a prudent investment strategy.

39. Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. 729.

Returning to our previous example, the restaurant chain would continue operations using the current restaurant format until a plan was confirmed. At that time the new owners could be expected to adopt the optimal investment policy—reformatting the restaurant—if that remains the most advantageous course.

The first task in fixing the amount of risk compensation payments would be to estimate a present value for the company at the time the investment decision is made on the assumption that the company will maintain a prudent investment strategy throughout the period of reorganization. Assume in the restaurant example that this value is \$95 million. As shown in Table 4, immediate pursuit of the optimal investment policy would give the interests of shareholders, which would have had little or no value under a policy of prudent investment,⁴⁰ a value of \$61.25 million. Pursuit of the optimal investment policy would reduce the present value of the unsecured creditors' claims from approximately \$95 million⁴¹ to \$43.75 million.⁴² Under our proposal, the shareholders would be obligated to compensate the creditors for this difference of \$51.25 million. Shareholders would make the payment by transferring shares of this value, which in this example would constitute 84% of their shares.⁴³

After making the risk compensation payment, shareholders, who would have recovered little or nothing under the current practice of prudent investment, will have shares with a present value of about \$10 million. Creditors, whose claims would have had a present value of approximately \$95 million under a prudent investment policy, will now have claims with a present value of \$43.75 million and shares with a present value of \$51.25 million, for a total present value of \$95 million. By the end of the

40. Since creditors are owed \$100 million in the hypothetical, if the prudent investment policy is followed and no changes are made in the company's operations, shareholders likely would receive nothing upon reorganization. There is always some upside potential, however, no matter what investment policy is followed—restaurant business may increase, for example, because competing businesses choose to liquidate, or consumers start eating out in greater numbers. Hence, even at the time the investment decision is made, it is possible the shares would have some positive value.

41. We assume that the present value of creditors' claims will approximate the present value of the company in a case where the latter value is less than the total amount of creditors' claims. The value of the company at liquidation could go up or down, of course, and since creditors bear all the downside risk but receive only some of the benefit of any increase in value, the actual present value of creditors' claims under an assumption that the company would continue a prudent investment policy could be a little less than the value of the company.

42. See *supra* table 3.

43. Their shares are worth \$61.25 million and they owe a payment of \$51.25 million, so they would have to transfer $51.25/61.25$, or 84% of their shares.

reorganization case, the values of these holdings will be different. If the restaurant reformatting strategy proves unsuccessful, the holdings of both creditors and shareholders will be worth nothing. However, if the reformatting proves successful, a 50% probability in our example, those holdings will be worth \$240 million. Creditors will receive full payment of their \$100 million in claims. The 84% ownership interest they received as risk compensation will add \$117.6 million to their recovery.⁴⁴ The shareholders' 16% interest in the company will be worth \$22.4 million.

Our purpose in requiring shareholders to compensate creditors for the risk imposed on the creditors by reopening the restaurants is to reduce the incentives for creditors to attempt to capture control of management and use that control to move the company toward an investment policy that is in their interests, but not in the interests of the company as a whole. Without risk compensation payments, creditors could gain \$56.25 million by forcing an immediate liquidation; under our proposal, creditors could gain only \$5 million by forcing liquidation. By practically eliminating the creditors' incentives to resist the optimal investment, we hope to free management to make it.

In determining the amount of risk compensation payments, we assume that a prudent investment strategy, essentially preservation of the status quo, is the best prediction of what would happen in the absence of the payments we propose. For this reason, prudent investment is the most appropriate baseline for measuring what creditors have "lost" through adoption of the optimal investment strategy.

Another way of understanding our proposal is to view a prudent investment strategy during the pendency of a reorganization as part of the creditors' contractual expectation when they extend credits, because it is such a common course of action. Risk compensation payments are compensation for suspension of this expectation. They can be analogized to adequate protection payments for secured creditors. The purpose of both types of payments is to protect creditors against deterioration in the value of their claims during the period of the automatic stay.⁴⁵ Both are

44. That is, 84% of \$140 million which equals \$117.6 million.

45. In one important respect, the two types of payments are different. The courts do not order adequate protection payments to compensate for risks imposed on secured creditors. If the debtor can insure against the risk, the court will order that the debtor do so. *See, e.g.*, *Carteret Savings Bank, F.A. v. Nastasi-White, Inc. (In re East-West Assoc.)*, 106 B.R. 767, 773 (Bankr. S.D.N.Y. 1989) (requiring that the debtor pay the creditor's insurance cost as part of adequate protection). If the debtor cannot insure against the risk, the court determines whether the risk is "significant." If it is, the debtor cannot impose the risk on the secured creditor. If the risk is not significant, no protection is ordered and the

reflections of the same basic principle of equity: when one party's rights are commandeered for the benefit of the group, the group should compensate that party.⁴⁶

Our rationale for proposing risk compensation payments is equally applicable to the common situation where a low-risk liquidation is the optimal investment policy, but the prudent investment strategy implies continuation of the business to explore the possibility that it can recover from its problems. Here too, we advocate requiring management to pursue the optimal policy, and requiring the creditors to compensate the shareholders for eliminating the possibility of a rehabilitation that under current practice causes their shares to have market value. We see a possibility, however, that shareholders will be doubly compensated if they receive risk compensation payments early in the case and, ultimately, the distributions under the plan of reorganization deviate from the absolute priority rule in their favor. We have described elsewhere the constellation of factors that bring about deviations from the absolute priority rule.⁴⁷ The closing and liquidation of the business is likely to reduce the size of the deviation from the absolute priority rule, but neither that, nor a court order that the risk compensation payment is in lieu of any deviation, is likely to eliminate all causes of the deviation or the deviation itself. Instead, we suggest that the court set the risk compensation payment at an amount that, coupled with the value of shares resulting from the likely subsequent deviation from absolute priority, equals the value the shares would have had if the company had followed a prudent investment strategy.

The creditor-shareholder dichotomy that we have employed throughout this paper is, in at least one important respect, an oversimplification of the problem with which we deal. In a large publicly held company, there are likely to be claims, and perhaps even shares, having several levels of priority.⁴⁸ A conflict, similar in nature to the conflict between creditors

secured creditor is compelled to bear the risk. To facilitate reorganization, the courts often determine that substantial risks are "insignificant." See, e.g., *In re O'Connor*, 808 F.2d 1393 (10th Cir. 1987) (holding that the risk that three gas wells to be drilled would be dry holes was insignificant); *In re Berens*, 41 B.R. 524 (Bankr. D. Minn. 1984) (finding a lien on crops to be planted and insured against hail damage to be adequate protection).

46. The bankruptcy courts have assumed, virtually without discussion, that unsecured creditors are not entitled to adequate protection. See, e.g., *In re Pioneer Commercial Funding Corp.*, 114 B.R. 45, 48 (Bankr. S.D.N.Y. 1990) ("[T]he concepts of adequate protection of an interest in property and the existence of an equity interest in property do not apply to unsecured claims.").

47. See LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1, at 143-58.

48. In our study of the bankruptcy reorganization of large, publicly held companies, we documented the frequency with which these multiple levels occurred. See LoPucki & Whitford,

and shareholders described in Part I of this paper, exists at each of the boundaries between levels of priority. However, we see no reason why the solution we have proposed for the two-party conflict is any less applicable to cases involving multi-party conflicts. The optimal investment policy should always produce value greater than would have been available under a policy of prudent investment. Those who benefit from the change in policy will still be better off even after they compensate those who suffered from the change.⁴⁹

The determination of the appropriate amounts of risk compensation payments cannot be a precise science. We contemplate that the question of whether the court should require risk compensation payments in the particular case could be raised by motion of any interested party, including management at the time it proposes a particular investment strategy.⁵⁰ Judgment, and perhaps even some guesswork, will then be needed to determine the present values of claims and interests under a prudent investment policy and their present values under an optimal investment policy.⁵¹ The process we contemplate for determining the amounts would be quick and dirty, much like the process currently employed for determining the amounts of adequate protection payments for secured creditors.⁵² The principal purpose of requiring risk compensation payments is to blunt incentives which drive creditors and shareholders to attempt to capture management and subvert investment policy to the less than optimal. Risk compensation payments in even a rough approximation of the appropriate amount should be sufficient to accomplish that purpose.

Corporate Governance, *supra* note 1, at 775 n.337.

49. An illustration of risk compensation in a multi-level priority situation appears in LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 791-94.

50. Management normally must obtain court approval before implementing an investment strategy that requires a significant change in the use of the company's assets. See *supra* note 17 and accompanying text.

51. To the extent there are, or will be, markets for claims and interests in these companies, the amounts for which the claims and interests are bought and sold may be useful evidence of the present values under an optimal investment policy.

52. To determine the appropriate amount of adequate protection payments, the courts must determine the amount of the decline that will occur in the value of the collateral during the time the stay is in effect. See *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assoc., Ltd.*, 484 U.S. 365, 382 (1988) (holding that an "undersecured petitioner is not entitled to interest on its collateral during the stay to assure adequate protection under 11 U.S.C. § 362(d)(1)"); *In re Bonner Mall Partnership*, 147 B.R. 50 (Bankr. D. Idaho 1992) (determining on motion whether a \$3.2 million shopping mall was declining in value).

An award of risk compensation payments would not violate any provision of current bankruptcy law. It might be justified as an exercise of the court's power to "issue any order . . . that is necessary or appropriate to carry out the provisions of this title."⁵³ Nonetheless, enabling legislation is desirable. A change from a practice of prudent investment to a practice of optimal investment combined with risk compensation payments is an important change in system philosophy. As the system currently operates, managements are unlikely to propose extreme-risk alternatives to prudent investment policy. Proposing such alternatives invites criticism by other parties in the case, and the courts are unlikely to approve them because of their extreme distributional consequences to creditors and shareholders. Courts that may be inclined to approve extreme-risk alternatives if those advantaged by them compensate those disadvantaged may have doubts about the legality of the necessary payments. The result is that implementation of the optimal solution to the debtor's problem is delayed until after confirmation. Legislation authorizing risk compensation payments could provide the necessary catalyst to change that practice.

V. SUMMARY

There has been much lamenting about unnecessary costs of bankruptcy reorganization. Research has shown that many of the supposed costs of reorganization are not nearly as great as once supposed.⁵⁴ In our judgment, one major source of inefficiency in Chapter 11 has been the investment policies normally adopted by companies during the pendency of a reorganization proceeding. These investment policies have emphasized maintenance of the status quo, avoiding quick liquidation of assets but also avoiding investments in acquisitions or new business strategies. We call this typical investment policy during reorganization a prudent investment strategy.

It is reasonable to assume that a prudent investment policy often is not a maximizing investment strategy for the firm. Yet it is adopted because it reflects a reasonable compromise among the competing interests of different classes of claims and interests. Senior classes will tend to favor conservative, liquidating strategies, since those classes bear all or most of the risk of losses from riskier investment strategies, yet will reap little or

53. 11 U.S.C. § 105 (1988).

54. See William C. Whitford, *What's Right About Chapter 11*, 72 WASH. U. L.Q. 1379, 1381-85 (1994).

none of benefits if a risk-taking strategy proves profitable. On the other hand, junior classes will tend to favor risk-taking strategies, since they will reap all or most of the benefits and bear little or none of the risks. Whether as an accommodation among the parties themselves, a management dynamic, or a compromise imposed by the courts, the prevailing response to this conflict has been the policy of prudent investment. Prudent investment is, however, often a suboptimal strategy. The loss to firm value from its pursuit can be substantial, particularly given the often extensive period companies spend in Chapter 11.⁵⁵

Commentators who have addressed this problem before us have recommended that control over investment policy during a reorganization be assigned to the “residual owner.” But determining who is the residual class of claims or interests at the beginning of the case and putting them in control does not in itself terminate the claims and interests of junior classes. Some or all of those junior classes may nevertheless be “in the money” if the firm is successful during the reorganization. Because those classes continue to own some of the possible benefits from risk taking, the incentives of the residual owners to take risks remain less than optimal until the end of the case. It will not be in the interests of the residual owners to take all risks necessary to maximize the value of the estate. While by definition the residual class of claims or interests bears some of both the upside and the downside risk of future investments, it would only be by coincidence that these risks would be equally balanced. Almost inevitably, the residual class will have more of either the upside or the downside risk, and hence have incentives to favor investment strategies that are either more risk prone or more risk averse than maximization principles imply.

Our suggested solution to the problem of prudent investment policy is to mandate that management adopt maximizing investment strategies and provide for “risk compensation payments” to any class of claims or interests disadvantaged by adoption of a maximizing strategy, as compared to current normal practice of a prudent investment strategy. The payments would be made by the classes benefitting from adoption of the maximizing strategy. They would not be cash payments, but rather would take the form of transfer of some of the claims or shares from the benefitting classes to the disadvantaged classes. The purpose of risk compensation payments is

55. In our study of 43 reorganizations involving large, publicly held companies, the average duration of the proceeding exceeded two years. See LoPucki & Whitford, *Venue Choice*, *supra* note 1, at 31 n.68.

to reduce the incentives of disadvantaged classes to resist the adoption of maximizing strategies by enhancing the benefits they receive from adoption of that investment strategy. In that sense this proposal can be seen as a very practical one, designed to counteract the norms or system dynamics that so often cause management to follow a prudent investment strategy. From a normative perspective, risk compensation payments can be seen as similar to adequate protection payments to secured creditors. Both payments reflect the policy that if bankruptcy is to interfere with normal contractual expectations of some classes for the collective good of all claimants in the proceeding, then compensation should be made. Here, normal contractual expectations with respect to investment policy during the proceeding are assumed to be reflected in the prudent investment strategy.

