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ESSAYS

CONTROL RIGHTS, PRIORITY RIGHTS, AND THE CONCEPTUAL FOUNDATIONS OF CORPORATE REORGANIZATIONS

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INTRODUCTION

THE modern approach to corporate reorganizations begins in a curious place. Everywhere else in corporate law, we focus on those who control the firm and on when others should be able to go to court and reverse their decisions.¹ With respect to corporate reorganizations, however, we ignore these questions and instead focus on priority rights.² Our lodestar is the real estate foreclosure. A real estate foreclosure is an actual sale of a physical asset, and the proceeds of the sale are distributed to old creditors and shareholders according to nonbankruptcy priorities. A reorganization is

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¹ See Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991); R.H. Coase, *The Nature of the Firm*, 4 *Economica* 386 (1937); Symposium, *Contractual Freedom in Corporate Law*, 89 *Colum. L. Rev.* 1395 (1989); Edward Rock & Michael Watcher, *Islands of Conscious Power: Law, Norms and the Self Governing Corporation*, 149 *U. Pa. L. Rev.* 1619 (2001); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role*, 80 *Tex. L. Rev.* (forthcoming 2001).

² See, e.g., Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 *J. Legal Stud.* 127 (1986); Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 *Yale L.J.* 1238, 1250-54 (1981); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 *Ann. Surv. Am. L.* 9, 11 n.6.

also a sale, albeit a hypothetical one, and the proceeds of the sale (usually in the form of new claims against the reorganized firm) are again distributed to the old creditors and shareholders. Hence, nonbankruptcy priorities should be respected here as well. According to this conventional wisdom, the primary challenge in the law of corporate reorganizations lies in devising a process that allows us to respect priority rights when there is not an actual foreclosure with competing bids.³

In this paper, we show that this conventional understanding of corporate reorganizations is wrong. It might seem that the primary question when all cannot be paid in full is who gets what, but this question is in the first instance merely distributional. It concerns only the size of the slices, not the size of the pie. Rational investors are indifferent to the priority they enjoy in bad states as long they enjoy a competitive risk-adjusted return on their investment. Hence, the central focus of corporate reorganizations should not be upon priority rights. Instead, as in corporate law generally, it should remain upon how the firm's assets are used and who controls them. Investors care intensely about ensuring that control of a firm's assets resides in able hands in good times; they care even more in bad times. When a firm is in financial distress, a large part of its value can be lost in a short period of time.⁴

³ Such articles have become a staple of bankruptcy scholarship. For a recent example, see Lucian Arye Bebchuk & Jesse M. Fried, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 *Harv. L. Rev.* 2386 (2001). There are many others. See, e.g., Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 *Yale L.J.* (forthcoming 2001); Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 *J.L. Econ. & Org.* 523 (1992); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 *Harv. L. Rev.* 775 (1988); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 *Colum. L. Rev.* 527 (1983).

The focus of the academic literature on priority rights can be traced to Bonbright and Bergerman's 1928 paper. James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 *Colum. L. Rev.* 127, 165 (1928). In contrast to virtually all who followed, however, they examined the wisdom of the absolute priority rule critically: "The old doctrine of absolute priority is probably not well adapted to the corporate form of organization, and its place may properly be taken by a modified form of the doctrine of relative position." *Id.* at 165.

⁴ For example, Merry-Go-Round, a retailer of teen fashions, found itself in Chapter 11 with more than \$100 million in cash. But less than a year later, the money was gone, as was most everything else. The creditors were left with only a cause of action against the management consultants who had advised the firm during the bankruptcy.

The starting place for corporate reorganization scholarship since the 1930s—the real estate foreclosure—ignores the question of control.⁵ Real estate foreclosure turns tangible assets into cash. With such a sale, there is no need to decide whether to liquidate the firm or to replace the current managers. These decisions can be entrusted to the new buyer. The only question is the distribution of cash among old creditors and shareholders. By contrast, in a reorganization that might last months or years, we must ask whether to continue the firm, how to identify those who will run it, and how to monitor them.⁶ About these questions, the real estate foreclosure analogy has nothing to say.⁷

Moreover, the foreclosure analogy leads to a method of allocating rights among old investors in the new entity that is affirmatively suspect. This distributional scheme—the absolute priority rule—demands that shareholders of insolvent firms be wiped out in the event of a reorganization. This rule exists uncomfortably with a persistent and pervasive feature of the capital structures of all but the largest, publicly held firms. In smaller firms, there is a near identity between shareholder and manager.⁸ The value of such

See Elizabeth MacDonald & Scot J. Paltrow, *Merry-Go-Round: Ernst & Young Advised the Client, but Not About Everything*, *Wall St. J.*, Aug. 10, 1999, at A1. Similarly, two years ago, a retailer of athletic shoes, *Just for Feet*, lost tens of millions of dollars as it spiraled from financial success to bankruptcy in only a few months. See Carrick Mollenkamp & Kelly Greene, *How Just for Feet Wound a Path from Supremacy to Financial Peril*, *Wall St. J.*, *Southeast J.*, Nov. 3, 1999, at S1.

⁵The first paper to squarely fix on the foreclosure analogy is Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 *Va. L. Rev.* 541, 541–42 (1933).

⁶These questions of control arise in any reorganization regime other than a speedy and mandatory auction. Indeed, the distinctions among Chapter 11 and market-oriented approaches such as those suggested by Bebchuk, *supra* note 3, at 781–97, and Aghion et al., *supra* note 3, at 532–43, may be quite small. See Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decisionmaking*, 17 *J.L. Econ. & Org.* (forthcoming 2001).

⁷Indeed, the argument in favor of mandatory auctions in lieu of any complex reorganization mechanism lies primarily in the way such auctions obviate the need to answer these kinds of questions. See Baird, *supra* note 2, at 138–45.

⁸See Venky Nagar et al., *Ownership Structure and Firm Performance in Closely-Held Corporations* (June 2000) (working paper, on file with the Virginia Law Review Association) (finding that 84% of closely held firms examined had four or fewer stock holders); see also Allen N. Berger & Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 *J. Banking & Fin.* 613, 628–29 (1998) (reporting that 86% of small firms are run by an owner/manager).

firms as going concerns depends upon the firm-specific human capital of its manager.

To be sure, if the firm lacks any value as a going concern, it should be liquidated. In such a case, there is an actual sale and nonbankruptcy priorities should be respected. But a significant number of firms have value as going concerns, and this value can be preserved only if the current manager remains in place and continues to hold the equity of the firm. When such a firm is kept as a going concern, a deal must be struck with the current manager one way or another. The dynamics of these renegotiations are such that the absolute priority rule likely has no effect on the share of the firm the manager enjoys after the reorganization, nor does it change her incentives beforehand. In short, modern scholars of corporate reorganizations have asked the wrong question and then offered an answer that is very likely irrelevant.⁹

In this Essay, we reexamine the foundations of corporate reorganizations. More in harmony with the modern understanding of corporate law, our approach does not begin with the real estate foreclosure and does not assume the centrality of the absolute priority rule. With respect to small firms or firms in less developed capital markets, we show that the question of whether to shut down the firm is of central importance. The challenge of the law of corporate reorganizations should be one of ensuring that this decision is in the hands of someone well equipped to make it.

The thesis put forward in this Essay is straightforward. When the managers and shareholders cannot be easily separated, control rights should lie in the hands of someone whose loyalties are aligned with the creditors, but the reorganization itself should not affect the value of the managers' equity interest. These principles

⁹The question is wrong because it focuses on a distributional concept that, in the first instance, has no effect on the value of the firm. The answer is irrelevant because creditors will renegotiate with managers to give them shares that the absolute priority rule would not let them have. Stated in the language of modern contract theory, a clause providing for an absolute priority rule is viewed as part of the initial investment contract. The clause, however, is not renegotiation-proof. Parties maximize their joint welfare by striking a different deal *ex post*. Indeed, the absolute priority rule may not even affect the outcome of bargaining after bankruptcy. For a formal bargaining model in which the absolute priority rule is irrelevant when control rights are lodged in the creditors, see Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 *J. Legal Stud.* 311, 339-40 (1991).

are not new, but rather forgotten. Although they barely made a toehold in the academic literature of the time,¹⁰ the early law of corporate reorganizations in this country adopted these principles in an environment in which it seems likely that they vindicated the creditors' bargain. Hence, it is this body of law to which we turn first.

I. EQUITY RECEIVERSHIPS, INVESTMENT BANKERS, AND THE PRIMACY OF CONTROL RIGHTS

A. *The Origins of Corporate Reorganizations*

Railroads exploded across the country in the years between the Civil War and economic downturn of 1890.¹¹ Over 70,000 miles of track were laid down in the 1880s alone.¹² Control of individual track often changed hands many times. Competition among the different lines intensified. A line that had a monopoly serving two cities could soon find itself in ruinous competition with a newly laid line connecting the same cities.¹³ Cartels came into existence and

¹⁰ Indeed, academics of this period did not acquit themselves especially well. They misunderstood the practice of corporate reorganizations and butchered the finance theory. They singled out for ridicule a practitioner, Robert Swaine, whose published work evidenced a far better mastery of both theory and practice. Compare Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 Colum. L. Rev. 901, 912–23 (1927) (arguing that relative priority and flexibility are necessary to reorganizations because giving equity holders continued equity is necessary to raise new capital and keep the business as a going concern), with Frank, *supra* note 5, at 551–53 (alleging that Swaine's theory was in error because he failed to read two cases in conjunction and suggesting that the value of the property of the old company is not irrelevant). Worse yet, these same academics put their theories into practice when they went to Washington during the New Deal. The damage done to the law of corporate reorganizations has taken decades to fix and has still not been set completely right. See *infra* notes 53–57 and accompanying text.

¹¹ For a general history of the role that railroads played in developing American law, see James W. Ely, Jr., *Railroads and American Law* (2001) (unpublished manuscript, on file with the Virginia Law Review Association).

¹² See Alfred D. Chandler, Jr., *The Railroads: The Nation's First Big Business* 13 (1965); D. Philip Locklin, *Economics of Transportation* 112 (7th ed. 1972). For a discussion of the intense competition among railroads, particularly those connecting Chicago with New York during this period, see William Cronon, *Nature's Metropolis* 81–93 (1991).

¹³ See Chandler, *supra* note 12, at 89–90; Henry H. Swain, *Economic Aspects of Railroad Receiverships*, 3 Econ. Stud. 53, 79–81 (1898).

then fell apart.¹⁴ It was a time of increasing but unpredictable government regulation, the most important examples of which were the Interstate Commerce Act of 1887 and the Sherman Act.¹⁵ For all these reasons, over half of the railroad track in the United States went through reorganization in the late nineteenth century, some more than once.¹⁶ These unprecedented events forged this country's law of corporate reorganizations.¹⁷

These railroads were worth keeping intact as going concerns even though their liabilities exceeded their assets. Once a railroad is built, much of the cost is sunk and there are no alternative uses for the assets (the long, narrow strips of real property, the rails, the bridges, and the ties). It might make sense to sell off parts to or acquire lines from others, but the basic shape of the firm would remain unchanged. Piecemeal liquidation of the disparate assets in which creditors held security interests would generate meager returns and was not a sensible option.¹⁸

Dealing with the financial distress in which the railroads found themselves was not easy. The capital structure of the railroads was byzantine. Railroads were initially built and financed in stages. Each stage was financed through mortgages whose form paralleled that of conventional real estate mortgages.¹⁹ Upon default, the bondholders had the right to foreclose on their collateral (a par-

¹⁴ See William Z. Ripley, *Railroads: Finance and Organization* 456-533 (1915).

¹⁵ See Ely, *supra* note 11, at ch. 3.

¹⁶ In 1893 alone, 27,000 miles of track in the United States went into receivership, more than existed in all of Britain at that time. See Stuart Daggett, *Railroad Reorganization*, at v (1908); Alfred D. Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* 53 (1990).

¹⁷ Excellent accounts of the evolution of modern reorganization law can be found in John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 Mich. L. Rev. 963 (1989); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69 (1991); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 Vand. L. Rev. 1325, 1353-76 (1998).

¹⁸ See Ripley, *supra* note 14, at 385-86.

¹⁹ See *id.* at 121-26. The financing of railroads until the 1850s was primarily through the sale of common stock. See Alfred D. Chandler, Jr., *Patterns of American Railroad Finance, 1830-50*, 28 Bus. Hist. Rev. 248 (1954). The need for debt financing arose with the tremendous expansion of railroads after that time. See Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 Bus. Hist. Rev. 1, 22-23 (1997). Moreover, state investment figured prominently in the early financing of railroads. See Stephen Salisbury, *The State, the Investor, and the Railroad* 31-61 (1967).

ticular stretch of track or a particular building).²⁰ Over time, railroads merged and formed large networks. The capital structure of these large enterprises, the first firms ever assembled whose capital outlays exceeded \$100 million, was a patchwork of many different kinds of bonds, often held by investors in Europe.²¹

The bonds themselves gave the bondholders the right to seize the collateral, but such a right was of small moment when the collateral—a ten-mile stretch of track between nowhere and nowhere—had little value.²² The contract offered no guidance as to what to do when the railroad remained in business.²³ It said nothing about the allocation of rights in the event of a reorganization.²⁴ Such silence is hardly surprising. At the time many of the investments were made, there had never been any multi-million dollar firms, let alone any that needed to be reorganized.²⁵

²⁰ See Ripley, *supra* note 14, at 121–26.

²¹ See Ripley, *supra* note 14, at 2–9; Augustus J. Veenendaal, Jr., *Slow Train to Paradise: How Dutch Investment Helped Build American Railroads* (1996). Besides the bondholders, there were few other creditors. Suppliers of coal and the like were paid on an ongoing basis. The cash for these outlays came from the issuance of receivership certificates. There was a market for these certificates, because they were accorded priority above existing mortgages. See Ripley, *supra* note 14, at 385–86. Because these obligations were small relative to the amounts owed the investors, and because the cooperation of the suppliers was important to keeping the railroad running, these suppliers were typically paid in full at the outset and they played no role in the reorganization. The practice was to pay debts for labor and supplies incurred in the ordinary course of business during the six months before the reorganization began. See, e.g., *Fosdick v. Schall*, 99 U.S. 235, 250–53 (1878).

²² See Ripley, *supra* note 14, at 126.

²³ See DeForest Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 *Harv. L. Rev.* 553, 585 (1954) (using Northern Pacific Railroad as an example of a company that had to go beyond the contract out of practical necessity). This point was largely missed by the academics who studied it. For an early and conspicuous exception, see Edward H. Levi, *Corporate Reorganization and a Ministry of Justice*, 23 *Minn. L. Rev.* 3, 19 (1938) (noting that a creditor's rights upon foreclosure cannot be equated with its rights in a reorganization).

²⁴ See Billyou, *supra* note 23, at 557.

²⁵ See Chandler, *supra* note 12, at 43. The circumstances of the Atchison, Topeka, & Santa Fe were typical. The road grew through accretion. By 1889, the Atchison, Topeka, & Santa Fe had become a railroad that connected the American southwest with the west coast, the Gulf coast, and Chicago. See Daggett, *supra* note 16, at 196–197. The system had 7,010 miles of track, almost half of what existed in Britain at the time. *Id.* at 198; Chandler, *supra* note 16, at 53. There were forty-one different types of bonds, each secured by different assets, no one of which had much value without the others. See Daggett, *supra* note 16, at 200. The line was economically viable; its operating revenues exceeded its operating expenses by \$6 million. *Id.* at 198. But

Railroad investors relied upon an extra-legal, noncontractual mechanism to protect their interests in the event of reorganization. When sophisticated European investors put their money in the railroads, they understood that railroads were a risky technology whose future was unpredictable. Because they held diversified portfolios, the investors had no a priori commitment to one distributional rule or another in the event of a reorganization. Rather than specify what should happen in the wake of events that no one could predict, they expected their agents to create both the procedures and the substantive rules that would maximize the value of the assets when firms encountered financial distress. For this job, they counted on the investment bankers that had arranged their investments in the first instance. The investment bankers were charged with the task of monitoring these railroads and orchestrating a reorganization when it was needed.²⁶

Investors could depend upon investment bankers and their lawyers to look out for their interests. The investment banker's livelihood required convincing future investors to invest in the bonds that they sold. As long as J.P. Morgan and Paul Cravath proposed restructurings that were in the joint interest of the bondholders, the bondholders would continue to trust them with their money. Investment opportunities that J.P. Morgan brought to Europe commanded a premium in part because Morgan was well-known for his ability to sort out the mess when things went badly.²⁷

these net earnings were insufficient to pay fixed interest costs and would likely remain so. See *id.* at 200 (showing interest exceeding \$9 million). Its outstanding debt totaled \$163 million. *Id.* at 200. Net revenues were well below 4% of outstanding debt. The firm was thus economically viable—its operating revenues exceeded its operating costs—but insolvent.

²⁶ Investment bankers were able to monitor the firms because they served on the boards of directors. For a general account of the work of investment bankers and their lawyers in equity receiverships, see Robert W. Gordon, *Legal Thought and Legal Practice in the Age of American Enterprise, 1870–1920*, in *Professions and Professional Ideologies in America* 70, 101–105 (Gerald L. Geison, ed., 1983).

²⁷ J.P. Morgan took the lead in reorganizing the Santa Fe, the Erie, and the Northern Pacific among others. Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* 171 (1977); see also J. Bradford DeLong, *Did J.P. Morgan's Men Add Value?*, in *Inside the Business Enterprise: Historical Perspectives on the Use of Information* 205, 205 (Peter Temin, ed., 1991) (concluding that participation by Morgan increased value of common stock by as much as 30%); Carlos D. Ramirez, *Did J. P. Morgan's Men Add Liquidity? Corporate Investment, Cash Flow, and Financial Structure at the Turn of the Twentieth Century*,

The existence of this bonding mechanism made up for the absence of the other mechanisms of monitoring corporate managers. Modern corporate law and the market for corporate control did not yet exist to police managers.

The investment bankers had a free hand to shape the law that would govern the restructuring of railroads, and, because they needed to return to the same investors again, they were drawn to rules that promoted the interests of investors as a group.²⁸ Hence, the early law of corporate reorganizations gives us a window into the creditors' bargain. When we examine the legal regime they crafted, we observe the primacy of control rights, their independence from cash flow rights, and the emphatic rejection of the absolute priority rule.

The investment bankers first had to decide who should run the railroad. At the time of reorganization, the old managers of the railroad were, for the most part, the insiders who built and operated the railroad and who formed alliances and cartels with other railroads. They controlled the railroad and held a portion of the railroad's shares.²⁹ Sometimes they were incompetent or corrupt and needed to be thrown out.³⁰ More often, they were highly skilled managers who knew how to run the railroad and keep it part of a larger network. The investment bankers—acting on behalf of the investors—usually wanted to keep the existing managers. The

50 J. Fin. 661, 664 (1995) (finding that Morgan's participation likely lowered the cost of capital).

²⁸ The observation we make here—that the need to return to the market constrains agents and forces them to maximize the value of the firm—is, of course, not new. See, e.g., Frank H. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650, 654 (1984).

²⁹ They did not, however, own anywhere near a majority of the shares. See Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* 51 (1932) (reporting that managers held 1.2% of the stock of railroads in 1922). As with bonds, much of the financing for shares came from abroad. Between 1890 and 1896, foreigners held between 21% and 75% of the common stock in the following railroads: Illinois Central (65%), Pennsylvania (52%), Louisville & Nashville (75%), Reading (52%), Great Northern (33%), and Chicago, Milwaukee & St. Paul (21%). Ripley, *supra* note 14, at 5.

³⁰ See, e.g., Daggett, *supra* note 16, at 126–28 (describing the removal of the president of Philadelphia & Reading).

managers knew best where the assets were and what deals existed with the other systems.³¹

In short, the investment bankers controlled the existing managers, gave them the right set of incentives, and also retained the ability to get rid of them. Moreover, the investment bankers continued monitoring until the firm had safely emerged from the restructuring and was operating free from financial distress.³² Investment bankers discovered that the best legal mechanism to accomplish these objectives was the equity receivership.³³

The equity receivership was a flexible procedure that J.P. Morgan and his contemporaries used to give railroads a new capital structure. The equity receivership of a railroad would begin when the investment banker persuaded a friendly, unsecured creditor to ask a federal judge to appoint a receiver to take control of the assets of the railroad.³⁴ The receiver the judge appointed, again at the prompting of the investment banker, would typically be the insider shareholders who were already running the firm.³⁵ The receivership changed the source of the existing managers' power to run the railroad but not their ability to run it.

Once the receivership was established, dissident creditors could no longer threaten to seize the railroad's assets, as the railroad was now in the control of the court, which in turn relied heavily on the investment banker and his lawyer. At this point, the investment banker persuaded the bondholders to deposit their bonds with a protective committee designed to represent their interests.³⁶ Repre-

³¹ See, e.g., *Cent. Trust Co. of N.Y. v. Wabash*, 29 F. 618, 620 (1886) (justifying appointment of insider as receiver on the grounds "of his long connection with and knowledge of the affairs of the road, and... his large experience in railroad matters").

³² See Ripley, *supra* note 14, at 404 ("[T]he main purpose of the voting trust is to pilot a reorganized road through the first critical years of trial."); Chandler, *supra* note 12, at 92-93 ("[B]y means of voting trusts the Morgans retained control for some time after reorganization.... [W]hen the managers in one instance objected to turning their roads over to the Morgans, Morgan, himself, is said to have retorted, 'Your Roads! Your roads belong to my clients.'").

³³ See Skeel, *supra* note 17, at 1356-57.

³⁴ See *id.*

³⁵ See *id.* In a study of 150 railroad receiverships between 1870 and 1898, insiders were appointed as the receiver in 138 cases. See Swain, *supra* note 13, at 98.

³⁶ See Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization

sentatives from the various protective committees then formed the reorganization committee. Unlike a real estate lender bent on foreclosure, this reorganization committee negotiated a new capital structure for the firm with appropriate adjustments to each investor's interests. The typical plan respected the priorities that creditors enjoyed outside of bankruptcy (as best they could be determined).³⁷

The court would approve the reorganization committee's plan, provided the committee had given everyone a chance to participate and provided that the plan itself enjoyed broad support among the creditors as a group.³⁸ Once the committee crafted a plan, the legal form did require that the court conduct a sale and entertain competing bids. The reorganization committee, however, was certain to be the top bidder. The committee could, for all practical purposes, bid whatever it wanted, up to the total amount of the indebtedness of the firm.³⁹ No one else during this period could amass the tens or hundreds of millions of dollars needed to make a competing bid.⁴⁰

For our purposes, one feature of these plans was especially striking. The plan usually gave the old shareholders the option to purchase shares in the reorganized firm, even though the firm was likely insolvent and not able to pay the creditors in full.⁴¹ The new stock, however, did not go directly to the new shareholders. Rather, it was usually placed in a voting trust.⁴² The trust, in turn, was controlled by the investment bankers who had initiated the reorganization in the first instance. The terms of the trust provided

Committees. Part I, Strategies and Techniques of Protective and Reorganization Committees 329-43 (1937) [hereinafter 1937 SEC Report].

³⁷ See Ripley, *supra* note 14, at 396-405.

³⁸ See, e.g., *Jameson v. Guaranty Trust Co. of N.Y.*, 20 F.2d 808, 815 (7th Cir.), cert. denied, 275 U.S. 569 (1927).

³⁹ The committee did not have to put up cash because it was able to "credit bid." Because the proceeds of any sale had to go to the most senior creditors, the committee could bid the amount of their claims. Any cash it was required to put up would be immediately returned to it because, as the holder of these senior claims, it was entitled to the proceeds of the sale. The only constraint upon the committee's ability to credit bid came from its obligation to pay cash to the few senior creditors who did not participate in the reorganization. See Frank, *supra* note 5, at 554.

⁴⁰ See *id.*

⁴¹ See Bonbright & Bergerman, *supra* note 3, at 133-45.

⁴² See Ripley, *supra* note 14, at 403-04.

that it was to last the shorter of some fixed period of time, such as five years, or until the first dividends were paid on the stock.⁴³

The plan included the old shareholders for two different reasons. First, a reorganization could only succeed with a fresh inflow of capital.⁴⁴ In a world in which capital markets were not well developed, other sources of cash often were not available. Attempts to raise capital from outside investors as opposed to shareholders met with, at best, mixed success.⁴⁵ In many instances, the only source of this cash was the shareholders.⁴⁶ Second, and perhaps more important, by offering stock at below market prices to the old equityholders while creating the voting trusts, the investment bankers ensured the ongoing participation of the old managers without relinquishing control of the railroad until the business was once again on a sound footing. The investment bankers thus had the ongoing ability to monitor the managers and decide whether they should remain in charge.

The equity receivership allowed railroads with debt obligations that were inconsistent with the firm's projected revenue to emerge from a reorganization with a sensible capital structure. The number of bonds would be dramatically reduced⁴⁷ and the new securities (such as preferred stock⁴⁸) allowed the investors to receive income if earned, but did not trigger a default if it was not.⁴⁹ Indeed, the continuing control of the investment bankers ensured that the managers of the railroad had a period of time to operate without having to answer to any investors other than the investment bank-

⁴³ *Id.*

⁴⁴ See *id.* at 407-08.

⁴⁵ See *id.* at 396 ("Experience, on the whole, tends to show that the main reliance must be upon the existing security holders; inasmuch as outside offerings for cash to the general public must be at such ruinous discounts as to preclude their use.").

⁴⁶ See *id.* at 396-97.

⁴⁷ To return to the example of the Atchison, Topeka & Santa Fe, the classes of bonds were reduced from forty-one to two, both of which had very long terms. The new capital structure proved sound, and the railroad thrived. The principal on the last of the bonds was repaid on schedule in 1995. See Daggett, *supra* note 16, at 213; Floyd Norris, *After 114 Years, It's Payday*, N.Y. Times, Business Day, July 1, 1995, at 33.

⁴⁸ Preferred stock was popularized through its extensive use in railroad reorganizations. See Tufano, *supra* note 19, at 22-23.

⁴⁹ See Ripley, *supra* note 14, at 393 ("A permanent reduction in fixed charges, that is to say interest on the funded debt, is the next [after raising of cash] essential of any successful reorganization plan.").

ers. Managers had to worry about their performance, not about actions from disparate creditors. The key to the success of the equity receivership lay in the control rights given to the investment bankers and their need to return to the market in the future. Their reputations turned on maximizing the value of the firm as a whole, not on their treatment of any particular bondholder.

As noted, this reorganization mechanism included a judicial sale, but this was an artifact of the need to conform to the formal dictates of the equity receivership, not something required by the bonds themselves or their owners. The judicial sale and distribution of proceeds extinguished the old claims against the firm. Extinguishing old claims against the firm was necessary to ensure implementation of the new capital structure.⁵⁰ Over time, the judicial sale increasingly became a legal fiction, and, by the 1930s, the pretense of an actual sale was dropped altogether.⁵¹ What was left was a negotiation among the firm's investors, orchestrated by the firm's lawyers and investment bankers.⁵²

The investment bankers' use of the judicial sale was a legal formality that hid much of what was going on in the equity receivership. This did not cause problems in practice, but it misled the academics who studied the equity receivership. These academics saw only the form.⁵³ They did not understand either the reputational constraints under which investment bankers worked nor the way in which voting trusts separated control rights from ownership rights. As a result, they could not explain departures from the absolute priority norm of the real estate foreclosure.

⁵⁰ See Robert T. Swaine, *Corporate Reorganization—An Amendment to the Bankruptcy Act—A Symposium*, 19 Va. L. Rev. 317, 324 (1933).

⁵¹ See *id.* at 324–27.

⁵² See *id.*

⁵³ Stated somewhat differently, the analogy at the heart of corporate reorganizations conflates the two distinct roles that investors play in a reorganization. They are the sellers who receive the proceeds of the hypothetical sale, but they are also the buyers who must decide what to do with the assets. Real estate foreclosure law enforces absolute priority in distributing the cash to the investors as sellers of the asset, but says nothing as to how the control rights are allocated among the investors as buyers. Much scholarship conflates these two distinct roles. See, e.g., sources cited *supra* note 2. Aghion et al., *supra* note 3, at 532–36, are a conspicuous exception. After implementing Bebchuk options, the high bidders vote among different reorganization plans. See *id.*

Some thought that corporate reorganizations required special treatment.⁵⁴ Most, however, thought they did not. In their view, the control investment bankers exercised and the departures from absolute priority that they promoted served to enrich corporate insiders, lawyers, and bankers at the expense of the public investor.⁵⁵ There were some who defended the equity receivership, but their explanations were not easy to follow.⁵⁶ Because these apologists were often themselves practicing reorganization lawyers, they

⁵⁴ See, e.g., Bonbright & Bergerman, *supra* note 3, at 165.

⁵⁵ The loudest and most intemperate voices came from the Yale Law School (including Thurmond Arnold, Jerome Frank, and William O. Douglas). See, e.g., Thurman W. Arnold, *The Folklore of Capitalism* 258–59 (1937) (“Large fees in such situations are the rule rather than the exception. Generally counsel fees in reorganizations constitute the largest single item for all services and usually exceed the compensation of the officers or groups which the attorney represents. The fees represent high-class boondoggling and bureaucratic red tape of so complicated a nature that it is almost impossible to say at what point they are unjustified. Moral judgments can scarcely be made. In addition to fees, key places in any reorganization offer opportunities for distribution of valuable patronage. The stakes of participation in reorganization have become so high that they often are a greater objective than the reorganization itself. The situation is very similar to the control of a municipal government by a political machine, with the possible exception that public opinion does not permit politicians to take any such percentage of the income of the municipality which they control.” (citations omitted)); Frank, *supra* note 5, at 546 (“The ingenuity of those seeking to bring about such legally condemnable transfers is inexhaustible.”); Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part I–VIII (1937–1940)* (written under the direction of William O. Douglas). But the view was commonly shared elsewhere and among economists as well as legal scholars. See, e.g., Norman S. Buchanan, *The Economics of Corporate Reorganization*, 54 *Q.J. Econ.* 28, 40 n.6 (1940).

⁵⁶ See, e.g., Swaine, *supra* note 10. Foremost among these was the lawyer Robert Swaine. See *id.* Swaine remains the most prominent exponent of the rules that governed the equity receivership. See Buchanan, *supra* note 55, at 40. Swaine did not have the benefit of the tools of modern finance. He was not able to call upon the now-familiar argument that reputation can serve as an important bonding mechanism. Hence, he could not easily explain the intuition that the participation of the investment banker in the reorganization was value-enhancing. Moreover, he lacked a rigorous way to define relative priority. He could not assert simply that a reorganization should not be a recognition event for managers and hence a reorganization should recognize the option value of their equity interests. Therefore, it was easy to dismiss his work as self-interested and incoherent, as many did. In a previous paper, we examined Swaine’s contribution to the law of corporate reorganizations. See Douglas G. Baird & Robert K. Rasmussen, *Boyd’s Legacy and Blackstone’s Ghost*, 1999 *Sup. Ct. Rev.* 393, 401–08.

were accused of greed and hypocrisy, and they were subjected to much self-righteous invective and abuse.⁵⁷

Vitriolic exchanges on the pages of academic journals are usually of little moment. These were different. The young academics that launched a concerted attack on the equity receivership were among those drawn to Washington during the New Deal.⁵⁸ Once in Washington, they grilled their erstwhile adversaries in public hearings and pushed Congress to enact rules that prevented investment bankers from overseeing the reorganization of firms for which they had raised the funds initially.⁵⁹ Investment bankers were taken out of the reorganization process and replaced with government-appointed trustees.⁶⁰ The blue-chip law firms that had orchestrated the legal proceedings were also shown the door. The absolute priority rule—the distribution scheme of the real estate foreclosure—was introduced.⁶¹

In the view of these New Dealers, bondholders needed to be protected from investment bankers and their lawyers. We now know that these public investors were not being duped by their investment bankers. Those who held diversified portfolios of these sorts of bonds over the long haul systematically outperformed the market.⁶² Nevertheless, the law of corporate reorganizations was transformed from a legal device that promoted the collective interests of investors into an unwieldy procedure overseen by a

⁵⁷ See, e.g., Frank, *supra* note 5, at 550–51 (“But the well educated reorganization lawyers knew too much. They were too much dominated by their wishes. Those wishes had blinded them to the obvious.”).

⁵⁸ William O. Douglas, for example, was brought to Washington to investigate equity receiverships. The public hearing to which he subjected Robert Swaine was one that left Swaine (as Douglas gleefully recounts in his autobiography) feeling as if he had been stood on his head and shaken until his fillings fell out. William O. Douglas, *Go East, Young Man* 260 (1974). As head of the SEC, Douglas put Chapter X in place, which excluded investment bankers from reorganizations. In his first opinion as a Justice of the Supreme Court, he inserted absolute priority into the newly enacted reorganization law. See Baird & Rasmussen, *supra* note 56, at 412–17.

⁵⁹ See 1937 SEC Report, *supra* note 36, at 897.

⁶⁰ See David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy* 5–12 (U. Pa. Law Sch. Inst. for Law and Econ., Working Paper No. 267, 1999), available at Social Science Research Network Electronic Paper Collection, http://papers.ssrn.com/paper.taf?abstract_id=172030.

⁶¹ See Baird & Rasmussen, *supra* note 56, at 412–17.

⁶² W. Braddock Hickman, *Corporate Bond Quality and Investor Experience* 338, 509 (1958).

government agency that repudiated the relative priority rule that had served investors well for many decades.

Subsequent legal reforms removed the government oversight and reintroduced the idea that old managers should continue to run the firm, but the devices that we rely upon outside of bankruptcy to control managers—such as the market for corporate control—were checked.⁶³ The investment banker was still banned. In short, the basic tenets of the equity receivership were turned upside down. Control rights no longer resided with an agent of the creditors, and relative priority was abandoned in favor of absolute priority. In the rest of this Essay, we show how these missteps explain much of what is wrong with the modern understanding of corporate reorganizations. In the next part, we begin by looking at priority rules. We later turn to the more important question of the allocation of control rights.

II. PRIORITY RULES

Absolute priority treats the reorganization as a recognition event that collapses all future possibilities to present values. The assets of the firm are then parceled out according to the liquidation priorities established by contract. Secured creditors are paid first and then general creditors. Only if all the creditors can be paid in full do the shareholders receive anything. The idea of relative priority is less easy to grasp, but the core intuition is straightforward. Relative priority preserves the option value of the owner/manager's equity stake in the firm. The reorganization changes the type of stake that the owner/manager holds in the firm, but not its value. For the owner/manager, the reorganization is not a recognition event that collapses future possibilities to present values.⁶⁴

⁶³ See, e.g., *In re Allegheny Int'l Inc.*, 118 B.R. 282, 285–90 (Bankr. W.D. Pa. 1990) (blocking attempt to gain control of firm in bankruptcy through the buying of claims). Bankruptcy law in the last few years, however, has increasingly turned to corporate law. The *Revlon* doctrine, for example, is increasingly being invoked in bankruptcy court. See Josef S. Athanas, *Using Bankruptcy Law to Implement or Combat Hostile Takeovers of Targets* in Chapter 11, 55 *Bus. Law.* 598, 608, 610 (2000).

⁶⁴ In a relative priority regime, we estimate the option value of the equityholder's residual claim against the firm at the time of its ultimate dissolution as a going concern (or any other event that, outside of bankruptcy, serves as a recognition event). Such an option trades for a positive price, even when the firm is insolvent. See Billyou, *supra* note 23, at 558, 585. Relative priority is not the same as the "second

Before we compare these two rules more formally, it is worth setting out the intuition underlying each of these priority rules. Absolute priority seems to represent the most straightforward interpretation of the relevant investment contract: Debt should be paid before equity. If parties want a more complicated distributional scheme, they can bargain for it. The intuition behind relative priority, by contrast, rests on the near identity between the managers and the shareholders. The relative priority rule allows the manager's incentives to be set by her compensation contract, a major component of which is equity in the firm. If the manager's contract is properly drawn, she can be dismissed or retained on the basis of her performance and the operational needs of the firm, not on whether the firm needs a new capital structure.

If the manager is responsible for the sorry condition in which the firm finds itself, she should be fired. If she remains the best person to run the firm, however, she should continue to run it as before. To ensure that her incentives are correctly aligned, she needs to continue to have an equity interest in the firm.⁶⁵ The need to reorganize the firm should change neither the amount we pay her nor the need to pay her in equity. When a reorganization leaves her interest unaffected as long as she does a good job, her incentives are much the same as those of a manager who enjoys a golden parachute when a merger is in the offing. Both rules encourage managers to make optimal decisions independent of the restructuring.

A. Absolute and Relative Priority Compared

Consider the following hypothetical. Manager runs Firm and, as Firm's sole shareholder, is entitled to its residual earnings. Investor

look" doctrine proposed by the 1973 Bankruptcy Review Commission, which gave equityholders warrants that would they could exercise five years after the plan was confirmed. See Report of the Commission on the Bankruptcy Laws of the United States, Part II § 7-303(3) (1973). This idea allowed equityholders to enjoy some of the upside, but exposed creditors to all of the downside. See Victor Brudney, The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule, 48 Am. Bankr. L.J. 305, 331-35 (1974). This proposal was unconnected with continuing participation on the part of old equity, and hence it was inconsistent with the concept of relative priority as traditionally understood.

"We define "manager" broadly here. In smaller firms, it is the person who actually runs the firm on a day-to-day basis. In larger firms, it is the person who controls the strategic decisions and oversees the day-to-day operations.

makes a capital contribution to Firm at $t=0$. At $t=1$, we shall learn information about Firm's future. We shall be either in a good or bad state of the world, each of which is equally likely. In the good state, Firm will be worth \$300 with certainty at $t=2$. In the bad state, Firm will be worth \$300 with one-third probability and worth nothing with two-thirds probability. Firm thus has a value at $t=0$ of \$200.⁶⁶ Firm's contract with Investor requires Firm to pay Investor the lesser of \$150 or the value of its assets at $t=2$. Firm is thus solvent at $t=0$. If we are in a bad state at $t=1$, there may be a recapitalization of Firm. In the event of a recapitalization, Investor's interest will be transformed into equity equal in value to the interest in Firm that it is then holding.

Let us assume that at $t=1$ we find ourselves in the bad state of the world. Firm is now insolvent.⁶⁷ How much equity should Investor receive in return for its right to receive \$150 at $t=2$? Investor's contract contains an important ambiguity. One can argue that Investor should receive 100% of the equity of Firm. Investor has a right to \$150, and Firm has an expected value at $t=2$ of only \$100. Hence, Investor should receive all the equity of Firm. This straightforward interpretation of the contract between Firm and Investor captures the idea of absolute priority.

An alternative interpretation is also possible, however. It too is consistent with the ultimate right of the creditors to be paid before equityholders. Investor is entitled to \$150 *only at* $t=2$. A recapitalization at $t=1$ does not entitle Investor to insist upon rights that it has only at $t=2$. No one is being paid at $t=1$. Investor's share of Firm in a recapitalization at $t=1$ should reflect the present value of its interest at $t=1$ independent of the need to recapitalize Firm. In bad states of the world at $t=1$, Investor has a one-third chance of being paid \$150 and a two-thirds chance of being paid nothing. Its interest at $t=1$ is therefore worth \$50. As the expected value of Firm at $t=2$ is \$100, to have its interest respected, Investor should receive an equity stake of 50% in a restructuring at $t=1$. We recog-

⁶⁶This figure is reached by multiplying the monetary amount by the percentage chance of reaching that state of the world. Thus, 50% (of \$300) plus 50% (of one-third chance of receiving \$300 and of two-thirds chance of receiving \$0). This equals \$200 (\$150 plus \$50).

⁶⁷It has a one-third chance of receiving \$300, which makes its expected value \$100. Its liability of \$150 exceeds its value.

nize the full value of that right *at the relevant time*—and this time is $t=1$ —by giving Investor an interest in Firm that is worth \$50.

It is one thing to note that there are two plausible characterizations of a debt contract's priority rule upon reorganization—absolute priority and relative priority. It is another to show that investors prefer one or the other. Under current law, there is no way to contract around bankruptcy and no reliable way in which the parties can specify the allocation of control rights once a firm is in bankruptcy. Investment contracts might specify absolute priority, but we cannot assume that absolute priority would be the regime of choice were everything up for negotiation. Inferences about the content of the creditors' bargain cannot be gleaned so directly.

B. Absolute Priority and the Large Firm

The case for absolute priority is strongest with respect to modern, large, publicly traded firms with their neatly hierarchical capital structures. When all the investment contracts are publicly traded in thick equity markets, however, the need for having a lengthy reorganization process largely disappears.⁶⁸ An actual sale of the firm is possible.⁶⁹ Indeed, the analogy to the real estate foreclosure becomes more than an analogy at this point precisely because an outright sale of all the assets of the firm to a third party is feasible. The assets of the firm are reduced to cash, which is then distributed, according to contractual priority, to the firm's erstwhile owners. All control rights are removed from the old investors and transferred to the buyer. The buyer decides upon the new capital structure. After the sale, we trust the normal mechanisms of corporate governance to resolve the asset-deployment issues.

For large firms, in which ownership and control are largely separate, the problem of hiring the right managers and giving them the right set of incentives does not drive a firm's capital structure. To be sure, managers of large, publicly held corporations do receive much of their compensation through stock and stock options, but the share of the equity that they hold is small. Even if the new owners of the firm decide to retain the managers, they can write

⁶⁸ Cf. Baird, *supra* note 2, at 145–47 (suggesting that the sale of a firm outright has many advantages over a reorganization if the obstacles to a sale can be overcome).

⁶⁹ See *id.*

new employment contracts. These contracts will cede a small part of the new equity to the managers.⁷⁰ Indeed, bidders may well approach managers in advance of a bid to ensure their continued availability. These negotiations have hardly anything to do with the firm's new capital structure, however.

There seems to be little reason for departing from absolute priority in modern publicly traded firms.⁷¹ Yet, as an initial matter, relative priority is equally attractive. In a world in which the Modigliani and Miller propositions hold,⁷² it makes no difference that, instead of absolute priority or some other "me-first" rule, we have a relative priority rule.⁷³ The vast majority of investors hold diversified portfolios and contribute no firm-specific skills. In a world with functioning capital markets and clear legal rules, the distributional rule is of little moment.

Absolute priority may be the appropriate rule in this environment only because it is the simplest.⁷⁴ Among investors in large, publicly traded firms, there is no need for more complex instruments. Any investor who wants an investment contract that provides for a different priority can create it by combining the right

⁷⁰ Granting options to managers while a large firm is reorganizing in Chapter 11 is common. Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 *J. Fin.* 425, 456 (1993).

⁷¹ Walter Blum made this point first. See Walter J. Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 *Harv. L. Rev.* 1367, 1375-76 (1954).

⁷² Modigliani and Miller demonstrated that in a world without taxes or bankruptcy costs, a firm's value is independent of its capital structure. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *Am. Econ. Rev.* 261, 268-71 (1958).

⁷³ Eugene F. Fama, *The Effects of a Firm's Investment and Financing Decisions on the Welfare of its Security Holders*, 68 *Am. Econ. Rev.* 272, 272 (1978). It is an unfortunate accident that modern economists returned to the study of corporate reorganizations in earnest when this point was not clear. The idea of absolute priority started as a convenient assumption. See, e.g., Jerold B. Warner, *Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims*, 4 *J. Fin. Econ.* 239, 239-41 (1977). Over time, however, it once again became an article of faith. Indeed, even the different language now used reflects this change. "Departures" from absolute priority have become "deviations" from absolute priority. See Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 *Wash. U. L.Q.* 1213, 1225 (1994).

⁷⁴ On the general virtues of simple rules, see Richard A. Epstein, *Simple Rules for a Complex World* (1995).

mixture of puts and calls.⁷⁵ Shareholders who want protection in bad states of the world can purchase a debt instrument, a convertible instrument, or a derivative.⁷⁶ Even if creditors are better off with an investment contract that provides for something other than absolute priority, secondary markets allow investors to enjoy any priority scheme they want.

Choosing between absolute and relative priority requires consideration of second-order concerns, primarily those related to ensuring that the post-reorganization capital structure is created at low cost.⁷⁷ Perhaps the most substantial cost is that of delay. The goal of a bankruptcy process should be to unleash the forces of nonbankruptcy corporate law as soon as possible. Appropriately, with respect to large firms, bankruptcy judges have increasingly assumed the role of auctioneer. The firm files for bankruptcy, often having already ensured that there will be at least one bidder for the assets, bids are solicited, and the assets are sold to the highest bidder. Control of the assets of a multi-billion dollar firm can change hands within a few weeks.⁷⁸ An auction regime ensures the appropriate allocation of control rights at a relatively low cost and again, with an actual sale, absolute priority makes the most sense.⁷⁹

⁷⁵ See Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 *Harv. L. Rev.* 460, 465–70 (1993); Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 *J. Pol. Econ.* 637, 649–54 (1973); Robert C. Merton, *Theory of Rational Option Pricing*, 4 *Bell J. Econ. & Mgmt. Sci.* 141, 141–42 (1973).

⁷⁶ Cf. Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 *J. Econ. Persp.* 21, 31–32 (1988) (putting forth the notion of owning “strips” in the firm).

⁷⁷ These include both the direct and indirect costs. The direct costs of Chapter 11 amount to about 3% of asset value. See Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 *J. Fin. Econ.* 285, 289–90 (1990). Total costs of financial distress for large firms seem to lie in the range of 10% to 20% of initial value. Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 *J. Fin.* 1067, 1077 (1984); Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 *J. Fin.* 1443, 1445, 1463 (1998).

⁷⁸ See, e.g., Laurence Zuckerman & Maureen Milford, *Court Approves American Plan to Buy T.W.A.*, *N.Y. Times*, Mar. 13, 2001, at C1.

⁷⁹ Here too, however, one must be careful. The actual sale does not eliminate the costs of renegotiations with the old managers when they are the ones best equipped to run the firm. See Per Strömberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests*, 55 *J. Fin.* 2641, 2663 (2000) (reporting that in the Swedish bankruptcy system, which auctions off all firms, 70 of 203 firms studied were bought by the old owners in a transaction financed by the senior lender).

C. The Creditors' Bargain and the Small Firm

The domain of corporate reorganizations properly understood may be quite small. Large firms can be auctioned off in Chapter 11 and an increasingly large number are. Most of the firms that file Chapter 11 petitions are small corporations⁸⁰ that have little value as going concerns.⁸¹ We have a bookstore in a local shopping mall. It offers a decent selection of books, but it does little advertising, offers little advice about which books to read, and depends on foot traffic in the mall for most of its customers. The premises are leased, the furnishings are generic, and the inventory can be readily bought and sold in a wholesale market. The rise of national chains, both brick-and-mortar and Internet-based, make such stores less viable. This store may not be able to offer the selection or the discounts of new competitors. Even if the owner/manager has done a good job and is not responsible for the financial distress, there is no special virtue in keeping the firm intact. It has no value as a going concern.⁸²

Not all cases are so easy. In a significant number of bankruptcy cases, we do not know whether the firm should survive. There is an established customer base, employees of long standing with firm-specific skills, and some assets that have been customized for the

⁸⁰ More than half the firms in Chapter 11 have assets of less than \$500,000, and more than two-thirds have assets of less than \$1 million. Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 *Am. Bankr. L.J.* 499, 529 (1999) (giving figures of 58% and 71% respectively).

⁸¹ For example, Warren & Westbrook, *id.* at 531, find that about 38% of Chapter 11 filings involve retailers and wholesalers. Going concern surplus will tend to be quite small in these firms, particularly because little firm-specific capital will be lost when a retailer or wholesaler is sold piecemeal.

⁸² Even if these firms are not worth reorganizing, Chapter 11 may nevertheless be the appropriate vehicle for resolving the problems such firms face. Chapter 11 is often the forum of choice for sorting out the problems of a failed business that has little value as a going concern. Cf. Samuel L. Bufford, *What is Right About Bankruptcy Law and Wrong About Its Critics*, 72 *Wash. U. L.Q.* 829, 833 (1994) (giving a couple of examples of uses of Chapter 11). For example, apart from a secured creditor that may have already repossessed its collateral, the only other creditor in the money may be the IRS, which is owed FICA and withholding taxes. The owner/manager of the business is likely to be personally liable for these taxes. Chapter 11 provides a forum for them to negotiate a settlement. See *id.* at 840-41; Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 *Int'l Rev. L. & Econ.* 223, 226 (1991). The role that the IRS frequently plays in small Chapter 11 cases makes inapt many of the conventional analyses of Chapter 11, based as they are on notions of the creditors' bargain.

firm's specific needs. The owner/manager seems to be the best person to run the firm, assuming it should be run at all. The firm cannot make debt payments, but it still seems to be able to cover its operating expenses each month. In many of these cases, there is a possibility that the firm is worth keeping intact as a going concern.

The capital structure is often quite different from what one sees in textbooks.⁸³ Lessors commonly make firm-specific investments in the real property on which a retailer conducts its operations. Suppliers issue trade credit and sometimes provide equipment.⁸⁴ Buyers may advance part of the purchase price. Relatives of the owner/manager may make loans to the firm, especially when it is in financial distress. Senior managers may defer salaries. If it is engaged in a joint venture with another firm, that firm may have provided equipment or capital. Where the value of the firm as a going concern is plausibly less than what the secured institutional creditor is owed, there is, as with the equity receivership, a diversity of creditors whose priority rights are hard to sort out.

The most salient feature of these small firms that may have value as a going concern, however, is not the exact shape of their capital structures, but rather the near identity between the managers and the equityholders. Consider the following case. An up-and-coming chef, convinced that she cannot find sufficient backing to open a new restaurant in New York, decides to take her talents elsewhere. She identifies a small town that has been a culinary desert for decades. The residents, however, have substantial incomes and survey data suggest that a first-class restaurant will be well-received. Raising money from friends and family, she moves to the small town with a hand-picked team. Local Bank provides a substantial loan to cover most of the capital costs. An old town house is remodeled. A wine cellar is stocked, and monogrammed china and flatware are purchased. An extensive publicity campaign is built around this chef and her distinctive culinary style.

Things do not go as planned. The cost of relocating the chef and remodeling the house exceeds estimates. The restaurant does gain

⁸³ See Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 383–89 (6th ed. 2000).

⁸⁴ See Berger & Udell, *supra* note 8, at 635 (stating that over 15% of small business assets are funded by trade debt).

a loyal following, but the revenues are less than expected and the costs higher. The chef cuts her own salary to a bare minimum.⁸⁵ The restaurant's revenues cover its operating expenses, but they cannot come close to making the requisite interest payments on the startup loans. The restaurant defaults on its loans to major creditors and enters Chapter 11. No one appears who is willing to buy the assets outright and then decide what to do with them.

There are several options. We might keep the restaurant and keep the chef. Because the restaurant is meeting its operating expenses, we do not need new capital. The chef may continue the current operations, or she may redesign the menu, lower the prices, and increase the number of tables. The important point is that the restaurant remains open with her running the show. Alternatively, we might decide to close the restaurant. Once we take this course, however, the chef and her team will move back to New York and all firm-specific capital will be lost.

Put differently, there are three separate decisions to be made in the case of a reorganization: electing to continue the going concern, choosing the managers to run it, and compensating them appropriately. The third decision is easy after we make the first two. As to the first two, however, for many small businesses there is effectively only one decision. The value of the firm, if any, comes from an owner/manager with firm-specific human capital. This kind of restaurant succeeds or fails with its celebrity chef. This problem is emblematic of what should be central to the debate. The first challenge of the law of corporate reorganizations lies in ensuring that such decisions are made correctly and at the right time.⁸⁶ In the

⁸⁵ In other words, if she were paid any less, she would pick up her stakes and go back to New York. The value of an entrepreneur's interest in the firm is typically diluted as the firm approaches financial distress. At the time a firm enters Chapter 11, the owner/manager rarely holds an interest worth more than her next best opportunity. Indeed, one can commonly observe entrepreneurs hanging on long after it has ceased making any economic sense for them to do so. See, e.g., *In re Pullman Constr. Indus., Inc.* 107 B.R. 909, 937 (Bankr. N.D. Ill. 1989) (describing a situation where managers continued to run the firm even though they were incurring personal liability for unpaid taxes of more than \$500,000).

⁸⁶ Put formally, we face here what is known in the finance literature as an optimal stopping (or "real option") problem. See Baird & Morrison, *supra* note 6, at 4. Unlike financial options, real options reflect a decision about how assets are used, not merely how they are owned. A real option involves a decision whether to take an action that, once made, is irreversible. See generally Avinash K. Dixit & Robert S. Pindyck,

next Part, we link this problem directly with the problem of priority rules.

III. SIMPLE MODELS OF PRIORITY IN CORPORATE REORGANIZATION

A. The Modern Model of Reorganizations

In the standard model of corporate reorganizations, financial distress sends a signal about managerial performance. Entrepreneur seeks funding for a project from outside investors. The project will have a good or a bad outcome. Success depends in part (but only in part) on the efforts of Entrepreneur before the good or bad state arises. The outside investors are not able to control or observe Entrepreneur's decisions. Once that outcome is realized, Entrepreneur makes no additional contribution to the value of the project. Under these assumptions, the outside investors might want an investment contract in which they enjoy absolute priority over Entrepreneur. In order to ensure that Entrepreneur has the right set of incentives, she has to take the biggest possible hit in the event of a bad outcome.

To the extent that Entrepreneur still receives a payoff of some sort in a bad state of the world, the outside investors have to receive an even larger share in the good states. At the margin, a rule under which Entrepreneur enjoys any payoff in a bad state of the

Investment Under Uncertainty (1994) (explaining real options and analyzing them in various settings). Consistent with its bias towards distributional questions, the bankruptcy literature itself has focused primarily on financial options rather than real options. See, e.g., Aghion et al., *supra* note 3, at 533–36; Bebchuk, *supra* note 3, at 785–93.

Real options, however, have begun to make their way into legal analysis. For application of real options to the decision whether to settle or litigate a claim, see, e.g., Bradford Cornell, *The Incentive to Sue: An Option-Pricing Approach*, 19 *J. Legal Stud.* 173 (1990); Peter H. Huang, *A New Options Theory for Risk Multipliers of Attorney's Fees in Federal Civil Rights Litigation*, 73 *N.Y.U. L. Rev.* 1943 (1998). Incentives to breach under different contract damages regimes have also been studied using real options. See Alexander J. Triantis & George G. Triantis, *Timing Problems in Contract Breach Decisions*, 41 *J.L. & Econ.* 163, 166–72 (1998) (showing that an expectation damages regime creates a real option to breach that the parties will tend to exercise earlier than is socially optimal). The timing of environmental regulation can be studied in the same way. See, e.g., Dixit & Pindyck, *supra*, at 405–18 (exploring the optimal timing of environmental regulations to control pollutants and the incentives of firms to comply with the Clean Air Act Amendments of 1990).

world is one that will result in some positive net-present-value projects not being funded. Under these assumptions, Entrepreneur will be able to raise the most money at the lowest cost only if she can grant an absolute priority debt contract.⁸⁷

We can see how the absolute priority rule increases the value of the debt contract (and brings about a corresponding decrease in the value of the equity) by returning to the ambiguous investment contract set out in Part II. Investor will part with \$125 for the contract that treats the restructuring at $t=2$ as a recognition event. There is a 50-50 chance that we shall be in the good state, in which case Investor is repaid \$150 with certainty. There is a 50-50 chance that we shall be in a bad state. When a reorganization is a recognition event, future values are collapsed to the present. In such a reorganization, Investor receives the entire value of Firm. In expectation, Firm is worth only \$100 (one-third chance of \$300 and two-thirds of \$0). The average of the two is \$125. This is the value of the investment opportunity at $t=0$, and thus it represents the amount of debt capital that Entrepreneur can raise by offering an absolute priority contract.

By contrast, if a reorganization is not a recognition event, Investor will contribute only \$100 to the venture. Investor still receives \$150 if things turn out well in the initial period, but it owns only half of the equity in Firm when the firm fares poorly. It will receive \$150 one-third of the time and nothing the rest. In bad states, its interest is worth \$50. The average of \$150 and \$50 is \$100. Hence, by offering a relative priority contract, Entrepreneur can raise only \$100 in outside debt capital.⁸⁸

To the extent that the goal of priority rules is to reduce the cost of debt financing, this familiar model of the firm suggests that we should treat the reorganization as a day of reckoning and then use

⁸⁷ See, e.g., Schwartz, *supra* note 73, at 1225 ("A bankruptcy scheme that encourages deviations from absolute priority reduces the assets that a firm can devote to investors in the failure state, and thus lessens the firm's ability to make a credible repayment promise. Thus, such a scheme would not, *ceteris paribus*, be part of an optimal debt contract.").

⁸⁸ Of course, as long as Entrepreneur needs only \$100, the relative priority contract does not make her worse off. Other things being equal, the value of her equity interest is going to be the difference between the value of the debt contract and the expected value of the firm under either regime. She can raise less in a relative priority regime, but the value of her equity stake is correspondingly higher.

absolute priority as our starting point. To be sure, the absolute priority rule is not optimal. When the outside investors cannot observe or control what the entrepreneur does, the absolute priority contract might lead the entrepreneur to entrench herself.⁸⁹ Such entrenchment increases Entrepreneur's value to the firm, which, in turn, may increase her bargaining position in the case of a reorganization.⁹⁰ Absolute priority might also lead her to postpone the reorganization past the optimal time.⁹¹ When the prospect of a bad outcome looms too large, Entrepreneur may have insufficient incentives to take steps that have a net positive present value.⁹² Conversely, absolute priority may induce Entrepreneur to take ever riskier projects when things start to go badly, as she does not bear the downside in the case of failure. Nevertheless, given the assumptions of the model, these qualifications do not keep the absolute priority rule from being a sensible baseline.

This model is eminently sound in principle, but it does not capture the dynamics of the reorganization cases that are interesting. Return to the case of the new restaurant and the chef. If the restaurant is closed or sold, the creditors will receive all that can be realized from the sale of the assets. This is true regardless of whether a regime is one of absolute or relative priority. The choice between priority rules matters only in those cases in which the restaurant has value as a going concern. But creditors can preserve that value only if they allow the chef to retain an interest sufficient to induce her to stay. The absolute priority rule, unlike the relative priority rule, gives the creditors the right to continue the firm as a going concern without the chef, but this right is meaningless. The restaurant has value as a going concern only if she remains in place, and she is already being paid only enough to keep her from quitting. Regardless of what the contract calls for, the creditors will

⁸⁹ See, e.g., Lucian Ayre Bebchuk & Randal C. Picker, *Bankruptcy Rules, Managerial Entrenchment, and Firm-Specific Human Capital* (University of Chicago, John M. Olin Law and Economics Working Paper No. 16, 2d Series, 1993).

⁹⁰ See *id.* Whether it will in fact have this result is unclear. If the manager is already being paid only enough to keep her from leaving the firm for another job, she will have no incentive to entrench herself.

⁹¹ See, e.g., Douglas G. Baird, *supra* note 82, at 230; Paul Povel, *Optimal "Soft" or "Tough" Bankruptcy Procedures*, 15 *J.L. Econ. & Org.* 659, 660-62 (1999).

⁹² See, e.g., Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 *Wash. U. L.Q.* 1159, 1177-79 (1994).

continue to give the chef the same amount in the same form—equity.⁹³ Put differently, the absolute priority contract is not renegotiation proof.⁹⁴

B. A New Model of Priorities in Reorganization

The standard model of corporate reorganizations neglects the fact that the old managers of the firm are needed if it is to remain as a going concern. We can capture this dynamic in the following model. Firm is founded at $t=1$ with a capital investment from Investor of \$30. Manager is hired to run the firm in exchange for equity in the firm. Firm is to be liquidated at $t=3$. At $t=3$, Firm will be worth \$100 with 75% probability if Manager dedicates herself mind, body, and soul to the enterprise between $t=2$ and $t=3$. If she does not work hard, then it will be worth \$100 with only 25% probability. If Firm fails, it will be worth nothing at $t=3$. Hard work costs Manager \$20.⁹⁵

Once Manager agrees to work for Firm, she has no ability to earn money elsewhere until after $t=3$. At $t=1$, there is a competitive market for such managers. They are entirely fungible. Managers are risk-neutral, but there is no way to tell whether they work hard or not. At $t=1$, Investor creates a capital structure in which she takes a note for \$60 and Manager receives 100% of the equity. Manager works hard because her expected return from working hard is \$30. (She has a 75% chance of getting \$40 (\$100 minus the \$60 paid to Investor in good states of the world.)) This is worth \$20 more than what Manager expects to receive if she shirks. (If she shirks, she has a 25% chance of getting \$40.)

At $t=2$, a new and entirely unexpected government regulation is passed that requires Firm to invest \$30 in new equipment. If the equipment is installed, Firm still is worth \$100 with 75% probab-

⁹³ We should expect, in other words, that when small firms have going concern value, the old managers will end up holding the equity of the firm. Even if the firm is auctioned off, we should expect the buyers of the firm to reinstall the old managers or, more simply, sell the firm back to them. In Sweden, such sale-backs are commonplace. See Strömberg, *supra* note 79, at 2644.

⁹⁴ On the general idea of renegotiation proof contracts, see Drew Fudenberg & Jean Tirole, *Game Theory* 174-76 (1991).

⁹⁵ Hard work in this model encompasses both effort level and the development of firm-specific human capital.

ity (assuming Manager works hard) at $t=3$. If the equipment is not installed, however, Firm must be shut down at $t=2$ and it will be worthless.*

Firm is worth keeping intact as a going concern. If Manager works hard, Firm still has an expected value of \$75 after the equipment is installed and the new equipment costs only \$30 and Manager's hard work costs only \$20. Hence, the sensible course is to install the equipment. Firm must find a new source of capital, because Investor will not make any additional contributions.⁹⁷ Investor approaches Finance Company. Finance agrees to contribute \$30 in return for a note for \$40.⁹⁸ Finance, however, insists that Firm's capital structure be changed. Finance will not lend unless Firm will be solvent at $t=3$. It will agree to loan \$30 in exchange for a \$40 note only if Firm can pay its debts in full and only if Manager retains the incentive to work hard.

If the parties had anticipated this contingency at the time of the original bargain, they would have provided that under these circumstances Investor would write down her own note to \$20, and Manager would still retain all the equity of the firm. Reorganization cannot be a recognition event for Manager. She needs to retain the same equity interest after reorganization that she had prior to reorganization in order to ensure that she works hard. The government requirement does not change matters. Firm needs a new capital structure because of its need to raise money to pay for the equipment. Yet the need for the new capital has nothing to do with Manager. The optimal contract before the exogenous shock was one that gave Manager 40% of the value of Firm at $t=3$. Only with such a contract will Manager work hard. If Manager has the optimal contract at the time of a restructuring and if the restructur-

* Of course, any exogenous shock outside the control of Manager would do as well for our purposes. Even if Investor cannot observe Manager's effort level, she should be able to observe such exogenous shocks.

⁹⁷ The possibility that Firm will need additional financing will not prevent Investor from making the initial investment. On our facts, Investor put in \$30 for a note that was worth, assuming no exogenous shocks, \$45. Even if Investor had anticipated a restructuring that wrote her note down to \$20 with an expected value of \$15, she still would have made the investment so long as the probability of the exogenous shock was 50% or less.

⁹⁸ If Manager works hard, Finance will receive \$40 with 75% probability, giving it an expected return of \$30.

ing itself is not connected with Manager's performance, then that contract should not change in the wake of the restructuring.

If Manager's contract could be costlessly renegotiated, a contract that explicitly called for absolute priority would generate the same outcome as one that provided for relative priority. Indeed, the costs of determining the shape of the relative priority contract before the fact might be as high as the costs of renegotiating the absolute priority contract after the fact. In the presence of these costs, the absolute priority and relative priority rules collapse into one another. Indeed, at the time of the initial contract, the parties may not be able to define priority rights in detail. The best that parties may be able to do is select a set of optimal procedures for making these decisions. Nevertheless, it is important to understand that absolute priority enjoys no privileged place in the creditors' bargain. This point emerges most clearly when we examine the way in which the relative priority rule worked in practice before the era of the equity receiverships was put to an end.

C. *Relative Priority in Action*

The model developed in the last Section is one in which there is little doubt about the value of the firm as a going concern or the importance of keeping the existing managers in place. These cases were common during the era of the equity receivership. A good example involves the reorganization of the Los Angeles Shipbuilding & Drydock Corporation.⁹⁹ Los Angeles Shipbuilding was a shipyard that built ships for the Navy during World War I. The only creditors of the firm held long-term bonds due in 1944. The shipyard languished during the 1920s, however.¹⁰⁰ By 1930 the shipyard could no longer meet its interest payments. There was a restructuring of the debt outside of bankruptcy under the terms of which interest was to be paid only as earned.

⁹⁹ The facts are set out in *In re L.A. Lumber Products Co.*, 24 F.Supp. 501, 504-06, 513-14 (S.D. Cal. 1938), *aff'd*, 100 F.2d 963 (9th Cir. 1939), *rev'd*, 308 U.S. 106. Further background on the case can also be found in 2 Arthur Stone Dewing, *The Financial Policy of Corporations* 1304-10 (5th ed. 1953).

¹⁰⁰ During this period, the United States entered into treaties that sharply limited the size of the Navy and hence the need for new ships. See Detlev F. Vagts, *The Hague Conventions and Arms Control*, 94 Am. J. Int'l L. 31, 37 (2000).

The shipyard continued to struggle during the 1930s, but then military spending slowly began to increase. The shipyard was one of the few firms with the expertise to win lucrative defense contracts, but it also needed substantial capital investments to be competitive. The shipyard had value as a going concern. It had large machinery and equipment that was geared to the building of ships for the Navy. Moreover, the owner/managers had contacts in the Navy and the technical expertise to build the kind of ships that the yard was designed to build.

Given the slow rate of increase in government spending, the shipyard in all likelihood would not have been able to pay the bondholders in full. The firm, however, was not in default to its bondholders and, given the terms of the workout, could not have been until the bonds became due in 1944. This presented a problem. The old bondholders were not willing to make any additional investments, and outside investors were unwilling to lend money to a firm that could not meet its existing obligations to other creditors.¹⁰¹

The bondholders of Los Angeles Shipbuilding would be better off if the firm went through a reorganization. If the claims of the creditors could be scaled back, the firm would be able to obtain new financing and remain a successful competitor in its industry. If the capital structure remained unchanged, however, the firm would, at best, limp along. The creditors would have a larger share of a much smaller company. The creditors, however, had neither the right to reorganize the firm nor the means to do so.

Los Angeles Shipbuilding illustrates one of the significant costs of treating a reorganization as a day of reckoning for owner/managers. They have no incentive to initiate a reorganization that wipes them out.¹⁰² A day of reckoning for the

¹⁰¹ Put in the terms of modern finance, the firm had a debt overhang problem. See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 *J. Fin. Econ.* 147, 164–65 (1977).

¹⁰² As we have noted, the reorganization does not necessarily wipe the owner/managers out. If the creditors can work together and if there is no bargaining failure, the parties might be able to overcome the inefficiencies of the absolute priority rule and renegotiate the contract with the managers. Whether creditors can work as one, however, is not clear, and bargaining failures are always possible, even when there is only one creditor. Nevertheless, in this case there is no collective action problem, the presence of which is a bedrock assumption of most justifications for

owner/managers is inappropriate when the firm finds itself in financial distress for reasons wholly unconnected with the performance of the managers. Here, for example, the managers had no control over the market for naval vessels. Their contract ensured that they would devote themselves to the firm and, at the margin, do the best they could, given the circumstances in which the firm found itself. The restructuring that needed to take place in 1937 was not the result of bad performance by the managers but rather was necessitated by the wholly exogenous events that gave rise to the need for new capital equipment. Nothing about the restructuring suggested that anything was amiss with the deal that was cut with the managers in the 1930 workout.

In this context, it makes little sense to have a restructuring regime that requires wiping out the interests of the shareholders. First, the managers themselves are the ones who understand the business and understand the need for new financing. The bondholders are scattered all across the country. None of them knows that the reorganization is necessary nor do they possess any of the skills needed to carry it off. Indeed, part of the value of the firm rests on the knowledge of the managers about potential sources of new capital. Even if the outside bondholders had the knowledge and skill necessary to reorganize the corporation and find new funds, they would lack the power to bring it about, as the firm is not in default on any of the bonds and will not be until 1944. The managers, for their part, have no reason to restructure the firm if a restructuring leaves them with nothing.

Nonetheless, let us assume that the creditors are able to work together. They can monitor the firm and obtain the new financing. Even under these assumptions, the creditors still have to contend with the bad incentives that the prospect of the reorganization creates. Such a reorganization regime is one in which the time horizon of the managers is dramatically shortened.¹⁰³ Instead of making decisions that maximize the value of their equity interest almost a decade hence, they make decisions that maximize the value of that interest over the very short term. They look for long-shot invest-

bankruptcy law. See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 *Yale L.J.* 857 (1982).

¹⁰³ This argument assumes that the threat to eliminate the interests of the managers in the reorganized firm is credible.

ments that might turn the fortunes of the firm around quickly. They make decisions that make them indispensable if the firm is reorganized, and they conceal information about the need for the reorganization.

Even if none of these concerns matter, after the reorganization takes place, the creditors still need to find someone to run the firm. The managers, with their firm-specific capital, are the best people to do it. Moreover, to ensure their incentives are correctly aligned, they need to be given equity just like anyone else who might be brought in to run the firm. The value of the equity the managers need to have, the amount needed to give them the right set of incentives, is equal in value to the equity interest of the firm that they required after the workout in 1930. In other words, assuming that they crafted the appropriate contract with the managers then, the creditors will again have to enter into the same contract with the same managers in a world in which the reorganization is a day of reckoning.

This example captures in a nutshell a fundamental weakness in treating a reorganization as a recognition event. Sudden discontinuities by their nature introduce bad incentives and costly renegotiations. Under the facts of the shipyard case as presented here, a more sensible legal regime is one in which the reorganization leaves unaffected the *value* of the managers' equity interests. If the bondholders need the managers to run the firm after the reorganization and if they are not overpaying them now, it makes no sense to have a reorganization regime that terminates the interests of managers. Such a rule merely forces creditors to enter into another round of negotiations after the reorganization. These negotiations will likely lead to the same contract. As long as the managers are not responsible for the events that gave rise to the reorganization, the reorganization should leave the value of their compensation unaffected.

Moreover, a reorganization regime that leaves the value of the managers' interests unaffected creates no discontinuities. They have no reason to postpone the reorganization and no reason to take short-term gambles. The underinvestment and overinvestment problems are created by the day of reckoning itself, not the distributional rule employed on the day of reckoning. The new capital structure does have some effects on the managers. These, however,

are largely positive. Because the firm is once again solvent, the risk that the managers will take long-shot gambles, for example, is significantly diminished. In competing for Navy contracts, for instance, the managers are less tempted to bid for the contracts that are more lucrative but harder to land. Neither do the managers have any need to entrench themselves, as they face no round of bargaining after the reorganization to renegotiate their contract.

The plan of reorganization in Los Angeles Shipbuilding left roughly a quarter of the equity in the hands of the managers. It attracted only two dissenting votes from among the many diverse bondholders. One of them had made a career of buying distressed bonds and holding up other creditors for the full amount of his bond by threatening to force a liquidation of the firm if they did not capitulate. Workers at the shipyard passed the hat among themselves to raise the money to pay him off.¹⁰⁴

IV. CONTROL RIGHTS AND SMALL FIRMS

In the preceding two Parts of the paper, we have shown that relative priority is a sensible way of allocating rights to a reorganized firm in those cases in which the firm should remain intact as a going concern with its existing managers in place. Moreover, the relative priority rule provides a healthy set of incentives before the fact. The relative priority rule gives the managers a share of the firm in bad states of the world only if the firm has value as a going concern.¹⁰⁵ Priority rules by their nature, however, tell us nothing

¹⁰⁴ See Dewing, *supra* note 99, at 1305 n.h. It should be noted that relative priority is easier to implement in the Los Angeles Shipbuilding situation than in the usual case. There was a concrete way to frame the inquiry into the value of the old shareholders' equity interest that the reorganization should leave untouched. They should enjoy an interest in the reorganized firm equal in value to the cost of an option to buy the shipyard in 1944 for the amount owed to the bondholders. Ordinary firms do not have a definite terminal date that provides the benchmark for the valuation of the equity interest, and one must approximate the likelihood that the firm would encounter a liquidation, third-party sale, or other event that would serve as a recognition event of the equity interest. This probability is then used to calculate the option value of the equityholders' interest in the firm.

¹⁰⁵ Relative priority does give managers an incentive to entrench themselves. Because they receive nothing if their skills are not needed, they may shape the firm's operations so that it cannot be run without them. The same is true of absolute priority. See Robert Gertner & Randal C. Picker, *Bankruptcy and the Allocation of Control* 12-13 (Feb. 16, 1992) (unpublished manuscript, on file with the Virginia Law

about the question of whether the firm should remain as a going concern. In this respect, a relative priority regime is as incomplete as one that mandates absolute priority.

A full account of the creditors' bargain must confront the question of who decides whether a firm should be liquidated. This question of institutional design should guide our selection of bankruptcy regimes. A regime of mandatory auctions solves the design problem by entrusting the shutdown decision to the market. The firm survives as a going concern only if a buyer for all the assets appears at the auction and decides to keep these assets in their current configuration after purchase. Chapter 11 entrusts this decision to the bankruptcy judge for as long as the firm is in reorganization.¹⁰⁶ Market-mimicking alternatives to Chapter 11 rarely confront this question. When they do, they tend to adopt the same mechanism as Chapter 11 with the shutdown decision again resting in the hands of the bankruptcy judge.¹⁰⁷

By the usual account, it is costly to entrust control rights to creditors. Just as the equityholders are likely to take too many risks, the creditors are likely to take too few. They face all the downside if things go badly and enjoy only part of the upside if things go well. This argument, however, loses much of its force in a relative priority regime or an absolute priority regime in which renegotiation is possible. If the firm has value as a going concern, the managers will end up with a share of the upside only as large as needed to ensure that they work on behalf of the firm. The creditors will receive all the other revenues that the firm generates.

Vesting control rights in creditors creates no bias towards liquidation in a relative priority regime. Consider the following case. Firm's assets can be liquidated and the creditors will receive \$90. If Firm is kept intact as a going concern, it will generate \$100. This increase in value is due solely to the efforts of Manager. If Man-

Review Association). As we have noted earlier, in small, closely held firms, one is not going to have a reorganization that excludes the owner/manager. Given that, there is little need for entrenchment. Only in situations where the firm can be sold apart from the current managers does the possibility of entrenchment arise.

¹⁰⁶ Technically, creditors can file a plan of reorganization that calls for liquidation of the firm. The predicate of filing such a plan, however, is that the bankruptcy judge not extend the debtor's exclusive right to file a reorganization plan. See 11 U.S.C. 1121(d) (2000).

¹⁰⁷ See Aghion et al., *supra* note 3, at 534.

ager cannot earn as much as \$10 in her next line of employment, the firm should not be liquidated, and it will not be. Manager's contract will pay her \$10, and the creditors will keep the firm intact. They cannot do better by liquidating. If, on the other hand, Manager can earn a wage above \$10 from alternate employment, she will not stay under her current contract and the creditors will have no reason to change it. The joint wealth of the creditors and Manager is maximized through liquidation. A relative priority regime embraces the idea that Manager's efforts (and the salary needed to induce them) are a cost of doing business. The creditors' interests are not skewed, at least not in the cases that matter.

Actual contracting practices suggest that vesting control rights in creditors in bad states of the world may be value-enhancing. When venture capitalists fund a start-up venture, debt rarely appears in the capital structure. Instead, the venture capitalist takes an equity interest that may, like debt, enjoy priority over the interest of the entrepreneur who starts the venture but is a species of equity nevertheless. For this reason, the firm is not eligible for bankruptcy, and the allocation of control rights and priority rights is entirely a creature of contract. By looking at these contracts we can, as in the case of the equity receivership, draw some inferences about the shape of the creditors' bargain. The venture capitalist's investment contract ensures that she enjoys the control rights in bad states of the world.¹⁰⁸ She has the ability to terminate the venture. That said, if she decides to continue the venture and retain the old managers, she must let them keep their equity stake.¹⁰⁹

¹⁰⁸ See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts 1-2* (NBER Working Paper No. 7660, 2000); Steven N. Kaplan & Per Strömberg, *How Do Venture Capitalists Choose and Monitor Investments? 3-4* (Dec. 2000) (unpublished manuscript, on file with the Virginia Law Review Association) [hereinafter *Venture Capitalists*].

¹⁰⁹ See *supra* notes 85-94 and accompanying text. The manager's equity vests over time. In effect, she is periodically paid in equity for the work that she does. When the firm needs new capital, the manager's equity interest is not wiped out, but rather is diluted according to a complicated formula. Finding good managers and keeping them committed are among the most important challenges a venture capitalist faces. They must choose them well and keep them committed to the firm as long as they are the best people to run it. Indeed, in deciding to make an investment initially, one of the most significant factors for the venture capitalist is the strength of the management team. The investment contract itself varies depending on the venture

One should not rest too heavily on this analogy in understanding the reorganization of small firms in Chapter 11, just as one cannot rest too heavily on the role of the investment banker in the equity receivership. Nevertheless, it should lead us to reexamine current law where creditors have little power over the threshold question of whether the firm continues as a going concern at all. Ordinary mechanisms of corporate governance are suspended. Creditors, even as a group, cannot liquidate the firm on their own initiative. Nor can they, as a group, oust the managers without a showing of cause. Managers are given agenda-setting authority. Any regime in which the reorganization takes time is suspect to the extent that it limits the ability of investors to decide whether to keep the firm intact and whether to keep the managers in place.

A sensible law of reorganizations should attempt to confront this state of affairs. In the case of many closely held firms, there is a large institutional investor.¹¹⁰ It should be able to assess the condition of the firm. This creditor is likely to know when the firm needs to be reorganized and is able to ensure that the managers make (or do not fail to make) major decisions correctly.¹¹¹ As with the investment banker in the day of the railroads and the venture capitalist in the case of start-up firms, the large institutional lender, the major supplier, or the real estate lessor may be the one best positioned to decide whether the firm should continue. They are also the ones who, after the initial continuation decision is made, can best craft a new capital structure that reflects the future prospects of the firm. Indeed in these cases, we may need only a procedure that halts the collection efforts of disparate general creditors. The institutional lender can make a decision about whether the firm

capitalist's perception of the strength of the management team. Moreover, the venture capitalist's ex ante assessment of the strength of the management team is still one of the strongest predictors of whether the firm ultimately goes public. See *Venture Capitalists*, supra note 108, at 4.

¹¹⁰ One study of the financing of small firms reports that roughly half of the firms surveyed have loans from financial institutions. Of the firms that borrow in this manner, roughly two-thirds borrow from a single institution. Over 90% of this borrowing is done on a secured basis. Berger & Udell, supra note 8, at 636-38.

¹¹¹ The bankruptcy literature often assumes that outside investors lack access to such information. Again, what we now know about venture capital contracts suggests that this is not true. See *Venture Capitalists*, supra note 108, at 9.

should continue as a going concern and make whatever arrangement with the old managers that is appropriate.¹¹²

Investors do in fact contract for such control rights when the legal regime permits it. In many workouts outside of bankruptcy, a senior secured lender insists that, in exchange for the restructuring of its debt, the debtor promise not to oppose a motion to lift the automatic stay in a subsequent bankruptcy proceeding.¹¹³ To the extent that these agreements are enforceable, they effectively implement a selective stay regime. The automatic stay applies to all other creditors, and the senior lender in effect retains the ability to seize its collateral, thus terminating the business. When the senior creditor decides that the business is no longer viable as a going concern, it can end the venture.

One can imagine other procedures as well. Some firms may not have a well-positioned creditor to exercise the continuation decision. For them, an optimal procedure may be one that allows for a relatively quick determination on the continuation question through a class vote. Only after the creditors decide that the firm should continue does it make sense to implement a new capital structure. Such a system might be a substantial improvement over existing law, which holds off creditor initiatives and combines the continuation decision and the capital structure decision. We do not exhaust the possibilities here. Rather, we seek to underscore what has been missing in the debate. Calls for bankruptcy reform need to confront squarely the issue of control rights.

CONCLUSION

The history of corporate reorganization practice has been one of innovation. Market actors faced with the need to further their long-term interests figured out how to use equity receiverships to reorganize firms in financial distress. In more recent times, they have used Chapter 11 to resolve mass tort liability and to effect a sale of assets in which the buyer can be confident it has acquired clean title. The contributions of academics and government actors, however, have been mixed. Reforms pushed by New Deal academics to pro-

¹¹² See Baird & Picker, *supra* note 9, at 337-40.

¹¹³ See Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 *Am. Bankr. Inst. L. Rev.* 85, 97-101 (1995).

protect the interests of ordinary investors proved to be counterproductive. The revisions of the 1970s failed to take advantage of what had been learned during the days of the receivership.

Every bankruptcy regime, whatever its genesis, must allocate control rights effectively. When times are good, the law empowers investors to craft governance structures that do this. Control rights matter even more when times are bad, but the law here fails to provide the necessary tools. Our debate about the law governing firms in financial distress has neglected control rights for far too long. We have forgotten the lessons of history. Then, as now, the problem of corporate reorganization is at bottom a problem of corporate governance.¹¹⁴

¹¹⁴ See David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 *Tex. L. Rev.* 471, 474 (1994) (arguing that corporate bankruptcy should be governed by the states like the rest of corporate law). Like many issues of corporate governance, the firm's investors are well situated to select the optimal procedures. See Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 *Tex. L. Rev.* 51, 53 (1992); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 *Yale L.J.* 1807, 1809 (1998).

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