

BARGAINING OVER EQUITY'S SHARE IN THE BANKRUPTCY REORGANIZATION OF LARGE, PUBLICLY HELD COMPANIES

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This Article reports some of the results of an empirical study of the bankruptcy reorganization of large, publicly held companies. We present data relevant to what many consider to be the central issue of reorganization theory—how the value of the reorganizing enterprise should be divided among the various claims and interests.¹ We demonstrate that there is indeed systematic deviation from the absolute priority rule in favor of junior interests; but, with respect to large, publicly held corporations, the debate about how to prevent these deviations is, for the most part, a tempest in a teapot—the difference between absolute priority and the actual outcomes of these cases is relatively small.

Current law provides a complex legal environment in which representatives of thousands of creditors and shareholders bargain over the disposition of billions of dollars in assets. Adjudication of cases within that environment is thought to be virtually impossible. Prior to this study, the operation of this system was largely inaccessible to scholars. This inaccessibility results largely from the sheer size of the cases, which makes it difficult to gain an overview, and from the private nature of the bargaining process as contrasted with adjudication.

Over the four years of our study, we collected and reviewed over 35,000 pages of written materials, prepared financial analyses of the distributions in each of forty-three cases according to a uniform set of valuation protocols, and conducted more than 120 interviews with lawyers who played key roles in negotiations leading to confirmation of reorganization plans. We hope our efforts will

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¹ See Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127, 127-35 (1986); Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 777-81 (1988); Jackson & Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 158-60 (1989); Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 528 (1983).

establish a more accurate factual framework upon which bankruptcy scholars will base their theories in the future.

In Part I of this Article, we describe the legal context in which the bargaining and settlement of major reorganization cases occur. Part II describes the history and the policies that have shaped the current legal rules. Readers already familiar with these subjects may wish to turn directly to Part III, in which we describe our methodology. In Part IV we present our findings as to the frequency of "settlement" in these cases. In Parts V and VI, we present our findings as to the terms of settlement, comparing the legal entitlements of various participants in hypothetical adjudications and their recoveries under the actual settlement agreements. In these parts, we also discuss the possible reasons for "gaps" between the hypothetically correct solutions in adjudication (as provided by the absolute priority rule) and the settled outcomes. Part VII discusses the implications of these empirical findings for bankruptcy policy.

I. THE LEGAL CONTEXT IN WHICH BARGAINING OCCURS

In the absence of bankruptcy proceedings, a creditor who remains unpaid after the debt becomes due can, by following the proper procedures, force the sale of enough of the debtor's business assets to pay the outstanding claim. Even a single creditor holding a sufficiently large claim may force the closing of a debtor's business. To avoid this result, debtors who are unable to make timely payment usually bargain with threatening creditors for extensions of time. A debtor who does not reach a satisfactory agreement has the alternative of filing a bankruptcy case. Upon the filing of a bankruptcy case, creditors lose their right to force liquidation under state law; subsequently, liquidation can occur only with the approval of the bankruptcy court.

As a practical matter, for large business debtors seeking to continue operations, a bankruptcy case must be brought under chapter 11 of the Bankruptcy Code. A primary public policy underlying chapter 11 is to identify the cases in which the "going concern value" of the business exceeds its "liquidation value" and then to shield the business against efforts to force liquidation in order that the entire going concern value can be realized for the collective benefit of creditors and shareholders.²

² The "going concern" value of a business is defined as the value the business will have if it continues to operate. In effect it is a discounting of anticipated future income

Bankruptcy law attempts to implement this policy through a variety of means. The most important is the formulation and "confirmation," or adoption, of a plan of reorganization, which typically alters the relationship between the debtor and its creditors and shareholders. For example, a plan may extend the time for payment of the debtor's obligations, reduce the amounts of those obligations, compel creditors to accept stock in full or partial payment of their rights, or even cancel stock or obligations without compensation.³ Ordinarily, the purpose of the chapter 11 plan is to alter the rights of creditors and shareholders such that the debtor will emerge from chapter 11 with a debt load that it can meet from anticipated future income.

A key feature of chapter 11 is that the debtor's management remains in control of the corporation.⁴ Not only is management in charge of the company's day to day business affairs, but it also plays a key role in the drafting of a reorganization plan. This role is essentially guaranteed by the debtor's exclusive right to propose a formal plan of reorganization during the first 120 days of the proceeding and during such extensions of that period as the court may allow.⁵ In a large majority of the cases in our study, extensions were routinely granted for the duration of the case.⁶ When exclusivity is maintained, the debtor corporation's management drafts and proposes a plan of reorganization after consulting and

to its present value. "Liquidation value" is the value that will be realized if the business is sold, either as a unit or in parts. Although traditionally it has been assumed that there usually is a substantial difference between these two values, this assumption has recently been called into question with regard to large corporations of the kind we are studying. See Baird, *supra* note 1, at 136.

³ In a large case, the plan of reorganization will be about 40 to 100 printed pages, plus attachments that may double its size. The plan may deal with a wide variety of issues in addition to those mentioned in the text. For example, it may provide the terms for sale of all or part of the business or restrictions regarding governance of the corporation. In most cases, the plan deals with the financial problems of several entities in the debtor's corporate group; in many of those cases the provisions governing reorganization of the various members are not the same.

⁴ This is an important change from the law that governed these kinds of cases before 1979. Under the old chapter X, a trustee was appointed to oversee management and draft the reorganization plan.

⁵ See 11 U.S.C. § 1121(c) (1988). Theoretically, the court could shorten the period to less than 120 days "for cause," but that seldom occurs. See 11 U.S.C. § 1121(d) (1988).

⁶ In the 43 cases in our sample, described later in this Article, exclusivity was "lifted," or not extended, in nine cases. In all other cases exclusivity was maintained for the duration of proceeding, even though most of the cases (27 of 43) remained pending for more than two years.

negotiating with the key representatives of the creditors and sometimes the shareholders. Those representatives may include "official" committees appointed by the United States Trustee,⁷ unofficial committees organized by members of the affected group, or other representatives, such as indenture trustees or the attorneys for the plaintiffs in a class action. Whether or not the representatives agree to a proposed plan, management can force a vote of the affected creditors and shareholders.

If the proponent pushes a proposed plan to a vote, each affected creditor and shareholder of the debtor receives a copy of the plan, information approved by the court as adequate for the evaluation of the plan in the form of a "disclosure statement," and a ballot to vote for or against the plan. The procedure for voting is complex. A plan must group the claims of creditors and the interests of shareholders into "classes," and it must provide the same treatment for all members of a class.⁸ If confirmation of the plan would alter the members' legal rights,⁹ they have the right to vote on whether to accept or reject it. If the holders of a majority in number and two thirds in amount of the claims or interests of a class vote in favor of the plan, the class is deemed to have accepted the plan.¹⁰ Dissenting creditors or shareholders who are grouped by the plan into classes that have accepted it are considered bound by the vote of approval, meaning that their continued dissent does not in itself prevent confirmation of the plan. They remain entitled to object to confirmation if the plan fails to satisfy any of several statutory requirements. Probably the most important is that the value each dissenting claimant will receive under the plan must be at least as

⁷ Although appointment of an unsecured creditors' committee is supposed to be automatic in chapter 11 cases, an equity committee is appointed only if the United States Trustee or the court deems it appropriate. *See infra* notes 171-72 and accompanying text. If the court authorizes the appointment of a committee, the United States Trustee selects its members.

⁸ The Bankruptcy Code provides that a class may only contain substantially similar claims or interests. *See* 11 U.S.C. § 1122(a) (1988). For example, one class may contain claims secured by a first mortgage on plant and equipment, another may contain all unsecured claims, and a third may contain the interests of preferred shareholders. We found cases in our study in which claims with potentially different rights were grouped in the same class when the plan provided that those claims were to be treated similarly. For example, subordinated creditors might be grouped with general unsecured creditors if the subordination provision was to be waived under the proposed plan.

⁹ A plan that does not alter the rights held by members of a class is said to leave them "unimpaired." *See id.* § 1124.

¹⁰ *See id.* § 1126(c).

great as the value that claimant would receive in liquidation.¹¹ If these requirements are met, however, the dissenters' legal rights can be modified despite their lack of consent.

Even if a class votes against the plan, a plan proponent may seek to have it confirmed under provisions of the Code appropriately referred to as the "cram down" provisions. Under these provisions, the court is required to confirm a plan even though some impaired classes have not accepted, provided the plan treats those classes "fair[ly] and equitabl[y]" and does not "discriminate unfairly" against them.¹² The condition that a plan be fair and equitable requires that senior classes receive absolute priority over junior classes; this condition is thus known as the "absolute priority rule." For example, absolute priority with respect to an objecting class of unsecured creditors means that the plan must either propose full payment to the members of that class or provide for cancellation without compensation of the interests of shareholders and of the claims of any subordinate creditor classes. A corollary of the rule is that the plan may not offer more than full payment of their claims to members of classes that are senior.¹³

While the absolute priority rule governs any adjudication of the rights of unsecured creditors and shareholders to share in the distribution under the plan, a variety of reasons may cause the representatives of creditors and shareholders to wish to settle their rights on a different basis. A principal reason is to avoid litigation over whether the standards for cram down are satisfied. A cram down determination requires a potentially difficult valuation of properties, such as debt instruments and shares, distributed to particular classes. Such valuation can be expensive and time consuming. In order to gain the support of all classes, however, it is necessary to provide at least some distribution to each class, regardless of the dictates of the absolute priority rule.¹⁴ Our

¹¹ This is the so-called "best interests of creditor" test. *See id.* § 1129(a)(7).

¹² *Id.* § 1129(b). There are a number of other conditions to confirmation. For example, at least one impaired class of creditors must accept the plan, *see id.* § 1129(a)(10), and the court must determine that the plan has been proposed in good faith. *See id.* § 1129(a)(3).

¹³ Although this provision is not express in the statute, the legislative history supports it, and there is a consensus among courts and commentators that it is a prerequisite to confirmation by cram down. *See Klee, Cram Down II*, 64 AM. BANKR. L.J. 229, 231 (1990).

¹⁴ A class that is to receive nothing under a plan is deemed to have rejected it and the plan is not even submitted to the class for a vote. *See* 11 U.S.C. § 1126(g) (1988). Hence, in this circumstance, confirmation could only be obtained by cram down.

Article primarily concerns the bargaining over these distributions to junior interests.

II. THE HISTORY AND THEORY OF BARGAINING IN BANKRUPTCY CASES

Under the law governing large corporate reorganizations prior to 1978, the parties in interest could not avoid formal application of the absolute priority rule or the necessity for a hearing by settling on the terms of a reorganization plan. As one prominent practitioner-commentator has put it, "Chapter X of the [former law] was interpreted . . . as precluding settlement by the creditors and equity holders involved in the case."¹⁵ The author did not mean that the parties in interest were prohibited by law from agreeing on a plan, but only that the agreement could not eliminate the need for a hearing to determine whether the settlement was strictly in accord with the absolute priority rule. Settlement could assure that the parties participating in the settlement would not actively contest the plan at confirmation, but the proponent of the plan would still have to prepare the case and present it to the court. This presentation included evidence of the value of the various instruments—notes, debentures, and other reorganization securities—to be distributed under the plan. Individual creditors or investors who were not parties to the settlement could and sometimes did contest those values. Even though the values being proven were considered to be nothing more than "a guess compounded by an estimate,"¹⁶ "[t]he imposition of the absolute priority rule required in every chapter X case that the reorganized debtor be valued by the bankruptcy court to insure compliance."¹⁷ Although the bankruptcy courts could, and in many cases probably did, confirm plans that deviated from the absolute priority rule,¹⁸ they could do so only after a possibly expensive hearing and even then only by ignoring their mandate.

This formalistic procedure for application of the absolute priority rule was adopted in 1939, following what was believed to

¹⁵ Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW 441, 441 (1984).

¹⁶ Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 313 n.62 (1982) (citing statement reported in H.R. REP. NO. 595, 95th Cong., 2d Sess. 222, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6181).

¹⁷ Broude, *supra* note 15, at 442.

¹⁸ See Note, *Absolute Priority Under Chapter X—A Rule of Law or a Familiar Quotation?*, 52 COLUM. L. REV. 900, 909-20 (1952).

have been widespread abuse of the previous equity receivership procedure, which operated largely outside the purview of the statutory bankruptcy laws. Under the old equity receivership procedure, it was possible for the parties in interest to a corporate reorganization, voting by classes, to agree on a reorganization plan—thereby reaching a settlement of their conflicting claims. A highly influential report of the Securities and Exchange Commission¹⁹ reported that in many reorganizations, powerful interests, particularly management and large banks, connived to reap a disproportionate share of the properties distributed in the reorganization. Victims were typically trade creditors and public debt holders. These groups found it difficult to organize and to hire representatives to negotiate on their behalf or to acquire the information needed to evaluate reorganization proposals put to them by “insiders.” The result frequently was approval of a plan providing far less to disadvantaged creditors than their due under the absolute priority rule. As a solution to this problem, in 1939 Congress required court approval of all reorganization plans, coupled with the mandatory appointment of a trustee in chapter X cases involving publicly held corporations; this enabled the court to receive information about proposed plans from an unbiased source.²⁰

In the 1978 Bankruptcy Code, Congress sought to eliminate the need for a judicial valuation of the properties to be distributed in every case, because this procedure had come to be viewed as unduly expensive and productive of delay.²¹ Congress accomplished this end by permitting a final resolution of the issue through bargaining among the representatives of the affected creditors and shareholders, followed by a vote. Although the drafters of the 1978 Code left

¹⁹ See SECURITIES & EXCH. COMM'N, 1 REPORT ON THE STUDY & INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL & FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 243-90 (1937). This report is widely known as the Douglas Report, named for William O. Douglas, the chair of the SEC at the time of the study.

²⁰ For excellent discussions of the 1939 changes and their rationale, see Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305, 314-16 (1974); Dodd, *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780, 787 (1942) [hereinafter Dodd, *Fair*]; Dodd, *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM. L. REV. 223, 225-38 (1938) [hereinafter Dodd, *Securities*]; Rostow & Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1338-40 (1939).

²¹ See Brudney, *supra* note 20, at 310-11; Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 545-46 (1973).

the absolute priority rule in effect for cases that reached adjudication, they anticipated that settlements might deviate from this rule, as they had before the 1939 reforms:

The bill does not impose a rigid financial rule for the plan. The parties are left to their own to negotiate a fair settlement. The question of whether creditors are entitled to the going-concern or liquidation value of the business is impossible to answer. It is unrealistic to assume that the bill could or even should attempt to answer that question. Instead, negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders. The bill only sets the outer limits on the outcome: it must be somewhere between the going-concern value and the liquidation value.

Only when the parties are unable to agree on a proper distribution of the value of the company does the bill establish a financial standard. . . . The important difference [from prior law] is that the bill permits senior classes to take less than full payment, in order to expedite or insure the success of the reorganization.²²

At least part of Congress's motivation in 1979 for encouraging settlements that deviated from the absolute priority rule was the assumption that the deviations would be in favor of the "public" shareholders and debentureholders, who today typically have junior status and lose out to banks and other financial institutions when the absolute priority rule is strictly applied.²³ By the 1970s, public shareholder classes were understood to be largely "little guys," rather than the investment bankers who were thought to have owned or controlled shareholder interests in the pre-1939 reorganizations.²⁴ Consequently, deviations from the absolute priority rule in favor of shareholders were not viewed so unfavorably.

Before this study, there had been considerable speculation in the literature that under the 1978 Bankruptcy Code, equity classes were receiving more than they are entitled to under the absolute priority rule.²⁵ The authors of these speculations generally assume

²² H.R. REP. NO. 595, 95th Cong., 1st Sess. 224 (1978) (footnotes omitted).

²³ See 124 CONG. REC. 34,004 (statement of Sen. DeConcini, Ariz.); see also Davis, *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L.J. 1, 64-65 (arguing that in a bankruptcy of a publicly held corporation, creditors are more likely than shareholders to be "institutional").

²⁴ See generally Dodd, *Securities*, *supra* note 20, at 233, 251-53 (stating that investment bankers, more than any other group, control shareholder interests).

²⁵ See, e.g., Baird, *supra* note 1, at 137 (noting that junior owners will favor delay in hopes of finding buyers who will pay higher prices for existing assets because they do

that concessions to equity are the price senior classes must pay to get all equity classes to accept a consensual plan and thus to avoid an expensive and time consuming cram down hearing. It is also commonly assumed that management, which often holds considerable bargaining leverage in negotiations because of its exclusive power to propose a plan and its easier access to financial information, holds out for a significant distribution to equity.²⁶

III. METHODOLOGY

As part of a broader study of the bankruptcy reorganization of large, publicly held companies, we sought to determine the frequency with which the parties were able to settle large bankruptcy reorganization cases, the degree to which the settlements deviated from the absolute priority rule, and the causes of the deviations.

Our sample consisted of all businesses which (1) filed proceedings under chapter 11 of the Bankruptcy Code after October 1, 1979; (2) declared assets of more than \$100 million as of the time

not have to pay the cost of additional searching, and that consequently, junior owners must be "bought out"); Bechuk, *supra* note 1, at 780 (stating that equityholders use delaying power to extract more value than that to which they are entitled). There has been one small empirical study prior to this one, the results of which tended to confirm the suspicion. See Franks & Touros, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 755 (1989) ("[The results of this study] suggest that . . . there are large deviations from absolute priority.").

²⁶ See, e.g., Bechuk, *supra* note 1, at 799. Bechuk states that "equityholders usually have the exclusive right . . . to file (and seek confirmation of) a reorganization plan." *Id.* Actually, the right is given to the "debtor," see 11 U.S.C. § 1121(b) (1988), and exercised by the debtor's management. Bechuk apparently assumes that the debtor will exercise this right for the benefit of shareholders, so that it is not necessary to distinguish the two. See also Franks & Touros, *supra* note 25, at 759 (speculating that managers deliberately and systematically overstate values and attempt to deceive judges in order to benefit shareholders); Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1060 (1987) ("[S]hareholders exercise indirect influence by controlling the selection of directors and influencing management. By exercising these rights, the public owners may be able to retain ownership through negotiation." (footnote omitted)). The legislative history indicates that Congress did not trust management to protect the interests of shareholders, but instead saw equity committees in that role. Congress believed that the debtor in distress has a "natural tendency . . . to pacify large creditors, with whom the debtor would expect to do business, at the expense of small and scattered public investors." S. REP. NO. 95-989, 95th Cong., 2d Sess. 10 (1978). Committees were expected to be the "primary negotiating bodies for the formulation of the plan of reorganization. . . . They will also provide supervision of the debtor in possession. . . . and will protect their constituents' interests." H. REP. NO. 95-595, 95th Cong., 1st Sess. 401 (1977).

of filing; (3) were the issuer of at least one class of security that was publicly traded; and (4) confirmed reorganization plans by March 31, 1988. There were forty-three such cases. For each of these cases we: (1) studied and extracted data from the plans, disclosure statements, confirmation orders, and the company's SEC filings; (2) read newspaper, magazine, and trade journal accounts of the case; (3) obtained information from published and unpublished sources about the market values of each type of property distributed under the plan; (4) did a financial analysis of the distributions; and (5) interviewed two to four attorneys or others who participated in negotiating the plan.

In our financial analysis, we gave special attention to a comparison of the distributions to unsecured creditors and shareholders. Our intent was to measure both the existence and the extent of deviations from the absolute priority rule in favor of shareholders. To make this measurement, in each case we sought to determine both the amount of creditor claims and the market value of the distributions to creditors and shareholders as of the day after confirmation.

In gathering the data, we encountered methodological problems. Disputed or unliquidated claims are frequently not determined until long after confirmation of the plan and we were commonly forced to rely on estimates of what would be the total claims in the case. Distributions made at the time of confirmation in cash or publicly traded securities presented few valuation problems. Many of the distributions, however, were made long after confirmation, and some distributions included securities, debt instruments, or other promises of future payment for which we could obtain little or no post-confirmation trading data.²⁷ In other cases, the amounts finally distributed depended upon the amounts to be realized after confirmation from the liquidation of assets or the determination of litigation. In such cases we sometimes had to rely on estimates.

We recorded the principles used to resolve specific problems in a set of "valuation protocols." Using these protocols we were able to compile estimates of the value of the distributions in all but two of the forty-three sample cases. These protocols enabled us to ensure that we acted consistently from case to case: because of this consistency, we have confidence that these estimated values permit

²⁷ In a few cases, we used the midpoint between bid and asked prices for securities because there were no actual trades.

us to draw reliable conclusions about the distribution to a class relative to the distribution to similarly situated classes in other cases.²⁸

It should be noted that if the cases in our study had been adjudicated, the courts would have valued the distributions by methods different from ours. We used post-confirmation trading values in all cases in which they were available—information that would not normally be available to the courts. Furthermore, legal

²⁸ While these protocols are too lengthy to reproduce here, they are available upon request and will also become, along with the rest of our data, part of the National Science Foundation data storage system at the University of Michigan.

Some examples may help to illuminate the nature of the decisions reflected in our protocols and their possible effects on our findings. When valuing a promise to pay money at a future date certain, we first tried to obtain a trading value for the debt instrument. If one was available, we discounted that value from the day the trade occurred back to the day after confirmation. If we were unable to obtain a trading value, we assumed that the payments would be made by the debtor as scheduled and discounted those payments to their present value as of the day after confirmation.

The rates we employed in discounting varied depending upon the date of confirmation and the length of time for which the creditor's "investment" was locked in. If the values were locked in for less than a year, we used the average of the "Prime Rate Charged By Banks" as reported in table A23 in the Federal Reserve Bulletin on the first day of the month in which confirmation occurred and the "money market" rate for three month U.S. Treasury bills in the secondary market as reported in table A24 in the Federal Reserve Bulletin for the month before confirmation. (That is, the Treasury bill rate is applied in the month after it is generated.) For obligations payable more than seven years after confirmation, we used Moody's Baa rate for corporate bonds as reported in table A24 of the Federal Reserve Bulletin (the "Baa rate"). For obligations of intermediate length, we applied blended averages of these two rates.

We did not vary the rates with the level of risk assumed, because we could develop no objective standard for evaluating the level of risk. Instead, we chose to treat obligations payable in more than seven years as though they had the same level of risk as a bond carrying a Baa rating from Moody's Investment Service. For obligations of lesser duration we assumed a lower level of risk. These levels of risk are probably lower than the risk presented by any of the securities or other obligations issued by debtors studied; for some it is probably much lower.

Our choice of discount rate had very little effect in most cases, because the securities or obligation traded shortly after confirmation and the discount period was short. Its most significant effect was in the few cases where the debtor issued long term obligations that bore inadequate rates of interest and did not trade. The effect of our choice was that in those cases our figures would tend to overstate the value of future payments promised to creditors, but our figures would be very unlikely to understate the true value. Since shareholders almost never received debt obligations, these difficulties had almost no effect on our valuation of their distributions.

While we sought to value distributions as of the day after confirmation and ignore fluctuations in value which occurred afterward, we made an exception for some distributions that depended upon the amounts for which particular assets could be liquidated after confirmation. In several cases, the values in these "liquidating trusts" were wholly speculative at the time of confirmation, but easily calculated once the liquidations were complete. In those cases we allowed ourselves the luxury of hindsight.

doctrine maintains that the market values of reorganization securities are frequently depressed below the "true" value of the securities and that the true value can only be determined by estimating the future income stream of the business and discounting it to present value.²⁹ More recently, this view has been criticized in the literature,³⁰ but to the extent it has validity, at least for some cases, it detracts from the meaningfulness of our results.

Our interviews with attorneys covered a wide range of topics, but each interview focused especially upon the reasons the parties chose to settle and the factors that influenced the terms of the settlement. In every case, we interviewed at least two, and usually more than two, attorneys who participated in the plan negotiations. By comparing the answers received from different negotiation participants, we were able to make judgments about the accuracy of the information.

IV. CASE OUTCOMES: THE FREQUENCY OF SETTLEMENT

Whether a large bankruptcy reorganization case has been "settled" is frequently a matter of interpretation. One might consider a case settled only if all of the thousands of creditors and shareholders involved affirmatively agreed to the terms of the plan, by voting or otherwise. Such a settlement is improbable. At the other extreme, most bankruptcy lawyers would consider a case "settled" if no major participant, such as an official committee or lead bank, came to the hearing and actively opposed confirmation. A number of other possible definitions of "settled" lie between these extremes. For example, one might consider a case settled if the creditors' and equity committees approved the plan by majority vote. Most pertinent to the present study, one might consider a case settled if all impaired classes accepted the plan by vote of the

²⁹ See, e.g., *Citibank, N.A. v. Baer*, 651 F.2d 1341, 1347-48 (10th Cir. 1980) ("With a newly reorganized company coming from the throes of bankruptcy, the actual market value of a share of stock may be considerably less than the pro rata portion of the going-concern value of the company represented by that stock."); *In re Equity Funding Corp. of Am.*, 391 F. Supp. 768, 773 (C.D. Cal. 1975) ("Instead, reorganization value is intended to approach the value that would prevail in a perfect market adequately stocked with willing and informed buyers and sellers."); Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 571-80 (1950) (indicating that, in calculating reorganization value, future conditions must be taken into account).

³⁰ See, e.g., *Roe*, *supra* note 1, at 559-70 (suggesting through empirical evidence that a reorganized firm's securities are not systematically undervalued).

requisite majorities, thus avoiding the necessity for a cram down hearing.

Table I shows the number of official committees appointed in each case, and whether those committees agreed to the plan which was finally confirmed by the court.

As shown in Table I, in no case was a plan confirmed without the approval of at least a majority of the members of the creditors' committee. In only two of twenty-two cases (9%) in which an equity committee existed at confirmation did the proponent of a successful plan push forward to confirmation without securing the agreement of the equity committee as well.

Table II shows the level of settlement in these cases by two additional measures: (1) Were there any impaired classes of creditors or shareholders who did not vote in favor of the plan?; and (2) Did those classes actively oppose confirmation? If a class receives nothing under a proposed plan, it is deemed to object, and no vote is taken.³¹ In Table II those classes are listed as not voting in favor of the plan, but there is a lowercase "a" to indicate that no vote was actually taken.

³¹ See 11 U.S.C. § 1126(g) (1988).

TABLE I

LEVEL OF COMMITTEE ACCEPTANCE OF TERMS OF CONFIRMED PLANS

Name of Case	Number of Official Creditors' Committees	Number of Official Equity Committees	Committees Failing to Approve the Plan
Air Florida	2	none	none
AM International	1	none	none
Amarex	2	none	none
Anglo Energy	2	1	none
Baldwin-United	2	1	none
Braniff	5	1	none
Charter	2	1	none
Combustion Equipment	4	1	none
Continental Airlines	3	none	none
Cook United	2	1	none
Crystal Oil	1	none	none
Dreco	2	1	none
Energetics	1	none	none
EPIC	none	1	none
Evans Products	3	1	equity
FSC	2	1	none
HRT	1	1	equity
Itel	2	none	none
Johns-Manville Corp.	8	none	none ^a
KDT	1	none	none
Lionel	1	1	none
Marion	1	1	none
McLouth	1	none	none
MGF	1	none	none
NuCorp	1	none	none
Oxoco	1	none	none
Penn-Dixie	2	1	none
Phoenix Steel	1	none	none
Pizza Time Theatre	1	none	none
Revere	1	1	none
Salant	1	1	none
Sambo's Restaurants	1	none	none
Saxon	2	1	none
Seatrain Lines	2	none	none
Smith International	1	1	none
Storage Technology	1	none	none
Tacoma Boatbuilding	2	none	none
Technical Equities	1	none	none
Towle	1	1	none
Towner	1	none	none
White Motor	1	1	none
Wickes	2	1	none
Wilson Foods	2	1	none
TOTAL	<u>75</u>	<u>22</u>	<u>2^a</u>

^a In the Manville case, before confirmation, the court disbanded two official equity committees that voiced opposition to the plan.

TABLE II
LEVEL OF CRAM DOWNS AND CONTESTS OF CRAM DOWNS

Name of Case	Number of Impaired Classes	Impaired Classes Not Voting in Favor of the Plan	Classes Contesting Cram Down
Air Florida	3	none	none
AM International	6	none	none
Amarex	20	equity ^a	none
Anglo Energy	5	none	none
Baldwin-United	7	none	none
Braniff	8	none	none
Charter	22	none	none
Combustion Equipment	8	warrants ^a	none
Continental Airlines	19	none	none
Cook United	7	sec. fraud ^a	none
Crystal Oil	8	Halliburton ^b	Halliburton ^b
Dreco	11	none	none
Energetics	9 ^d	none	none
EPIC	7	L. Partners ^c	none
Evans Products	13	equity ^a	equity
FSC	5	warrants ^a	none
HRT	6	equity	none
Itel	18	none	none
Johns-Manville Corp.	6	equity	none
KDT	5	none	none
Lionel	4	none	none
Marion	17	none	none
McLouth	6	none	none
MGF	6	equity ^a	none
NuCorp	8	equity ^a	sec. fraud
		sec. fraud ^a	
		insiders ^a	
Oxoco	8	none	none
Penn-Dixie	8	none	none
Phoenix Steel	7	none	none
Pizza Time Theatre	10	sec. fraud ^a	none
Revere	8	none	none
Salant	4	none	none
Sambo's Restaurants	6	equity ^a	none
Saxon	5	sec. fraud ^a	none
Seatrain Lines	8	none	none
Smith International	6	none	none
Storage Technology	6	none	none
Tacoma Boatbuilding	6	warrants ^a	none
		sec. fraud ^a	
Technical Equities	5	equity ^a	none
Towle	3	none	none
Towner	11	equity ^a	none
White Motor	7	none	none
Wickes	16	sec. fraud ^a	none
Wilson Foods	3	none	none
TOTAL	377	21	3

^a These are classes deemed to have rejected the plan without voting because they would receive nothing under the plan. "Sec. fraud" refers to security fraud claims.

^b Halliburton was a secured creditor.

^c "L. Partners" refers to a class of limited partnership interests.

^d There were nearly 200 technically separate classes of "Class A" secured creditors in this case totalling about \$12 million. Those classes have been disregarded for the purpose of this table because no reliable information is available as to the numbers failing to agree or actually contesting cram down. Their inclusion would not materially affect the level of agreement shown on this table. The claims of all these classes totalled only about \$12 million, the large majority of these classes agreed to the plan and none of the dissidents was aggressive enough at confirmation to be remembered by the lawyers we interviewed.

Table II shows a remarkably high level of plan acceptance. Only twenty-one of 377 classes (5.6%) did not vote in favor of the plan. Of these twenty-one, seventeen did not vote at all because they were to receive nothing under the plan and hence were deemed to object. As shown in the last column of Table II, only three of the 377 classes of creditors or shareholders (0.8%) actively contested confirmation of a plan.

Together, these tables demonstrate an extraordinarily high level of settlement. This finding is consistent with the comments of bankruptcy practitioners that "the underlying philosophy of chapter 11 is to force settlement."³² Practitioners generally state that a contested cram down hearing would be too complicated and too time consuming. Whether that is a realistic fear will be the subject of later comment in this Article.

V. THE TERMS OF SETTLEMENT: INSOLVENT DEBTORS

Our primary focus in this Article has been on distributions to unsecured creditors and shareholders. We were able to calculate a dollar value for these distributions for all but two of the cases in our study, using the methodology described in Part III.³³ Table III reports these figures for the thirty companies that were insolvent at the time of plan confirmation. We classified a company as "insolvent" if the total value of the distributions to unsecured creditors and shareholders was less than the estimated claims of the unsecured creditors. Table III orders the cases by the percentage of claims paid to unsecured creditors.

³² Broude, *supra* note 15, at 450.

³³ In the remaining cases, Phoenix Steel and EPIC, some distributions were of a nature that made reasonably accurate valuation impossible.

TABLE III
INSOLVENT^a DEBTORS: ADHERENCE TO THE ABSOLUTE
PRIORITY RULE

(1)	(2)	(3)	(4)	(5)	(6)
Name of Case	Percentage Paid on Unsecured Claims ^b	Distribution to Equity (in millions)	Total	(3) as % of (4)	Equity Committee Appointed?
			Distribution, Unsecureds and Equity (in millions)		
Seatrains Lines	0.5%	\$0 ^c	\$1.4	0	No
MGF	1.1%	0	2.0	0	No
Towner	2.5%	0	3.2	0	No
Air Florida	3.1%	0 ^c	6.0	0	No
Braniff	4.9%	1.7	35.4	4.9%	Yes
Amarex	7.8%	0	18.5	0	No
Oxoco	9.5%	0.4	11.2	4.0%	No
Technical Equities ^d	11.0%	0	6.6	0	No
Sambo's ^c	11.0%	0	unknown	0	No
Dreco ^f	11.7%	6.5	11.2	57.7%	Yes
NuCorp	13.4%	0	39.2	0	No
McLouth	18.2%	1.4	27.2	5.1%	No
Pizza Time Theatre	20.0%	0.5	23.0	2.2%	No
Crystal Oil	23.9%	3.9	52.7	7.5%	No
Evans Products ^g	26.5%	0	2.4	0	Yes
Combustion Equip.	27.7%	0.4	37.4	1.0%	Yes
Energetics	29.9%	3.0	14.5	20.8%	No
Tacoma Boat	29.6%	2.5	40.7	6.1%	No
Towle	35.6%	1.0	20.4	5.0%	Yes
FSC	37.6%	1.9	40.2	4.8%	Yes
Cook United	38.7%	2.3	28.1	8.1%	Yes
Marion	40.4%	0.9	60.9	1.5%	Yes
Saxon	41.2%	8.2	140.2	5.8%	Yes
Baldwin-United ^h	54.3%	20.0	259.1	4.8%	Yes
White Motor	60.9%	4.7	178.4	2.6%	Yes
KDT	62.6%	3.2	42.6	7.4%	No
Anglo Energy	64.6%	4.6	99.5	4.6%	Yes
Itel	64.9%	18.2	652.8	2.8%	No
HRT	68.5%	5.7	84.9	6.7%	Yes
Wickes	81.6%	63.0	1,100.4	5.7%	Yes

^a A debtor was considered "insolvent" if the total value distributed to unsecured creditors and shareholders was less than the allowed unsecured claims.

^b In determining the percentage of unsecured claims paid, classes were omitted if the amounts of claims in the class were in substantial dispute. Distributions to the classes omitted were not substantial for any of the cases on this table. In determining the total amounts distributed to unsecured claims, these same classes were included.

^c Equity received property under the plan, but the property was of inconsequential value.

^d The figure used for distribution to creditors is a rough estimate of a distribution not yet made.

^e In the Sambo's Restaurants case, the final distribution is not complete, but we have what we consider to be a reliable estimate of the percent of unsecured claims to be paid from the attorney for the trustee.

^f In the Dreco Energy case, insiders, who constituted management at filing, controlled 75% of the shares. They were able to secure a very favorable distribution to equity in part because their continued participation in the company was considered critical to its future success.

^g The distributions shown here were made to creditors of Evans Products, Inc., the parent company whose shares were publicly held. A total of \$175.3 million was distributed to all creditors of the subsidiaries. On the average, unsecured creditors of corporations in the group recovered 80.9% of their claims.

^h In the Baldwin-United case, a major payout (\$170 million) was made to rehabilitation funds established by two state insurance commissioners for the benefit of purchasers of single premium deferred annuities from Baldwin. We did not include this payout as a distribution to unsecured creditors because at the time of the bankruptcy filing, the rehabilitation funds held security interests in the stock of most of Baldwin's subsidiaries. These security interests were released with the filing. However, the payout was in full settlement of the annuitant's claims, including the unsecured portion. If we included this payout as part of the distribution to unsecured's, then the percentage distribution to equity would be reduced to 4.6%.

Three observations are apparent from Table III. First, though each of these companies was insolvent, in twenty-one of the thirty cases, creditors agreed to allow shareholder recoveries ranging from \$400,000 to \$63 million.

Second, of the nine cases in which equity received nothing, eight were cases in which unsecured creditors recovered less than 14% of their claims. With the sole exception of Evans Products, which will be discussed below, if creditors recovered at least 14% of the claims, equity was permitted to share in the distribution.

Third, in the cases in which creditors received more than 14% of their claims, there was no obvious relationship between the percentage of claims recovered by creditors and the size of the distribution to equity. This conclusion is evident from the fifth column of Table III. Certainly it is not possible to conclude that as the size of the distribution to unsecured creditors increased, the proportionate distribution to equity increased as well. We will explain the reasons for these phenomena in the order they are expressed above.

A. Why Does Equity Share in the Distribution?

In our interviews with the lawyers who conducted the negotiations in these cases, we asked why equity was permitted to share in the distributions. Only one attorney, who represented an equity committee, asserted that equity had any right to share under the absolute priority rule. Other participants in the same case dis-

agreed and attributed the distribution to other factors. In a few other cases, negotiations were conducted with the expectation that there might be a contest over equity's right to share in the distribution, but in none were they conducted with any real doubt as to who would win this contest. We have concluded that the creditors' agreements to the equity distributions listed in Table III were in no significant part the reflection of either real or supposed legal entitlements.

In describing why creditors approved these distributions to equity, the attorneys reported that "consensual plans" were highly desirable and that to obtain those consents "everybody has to get something." Several referred to the equity distributions as the "price of peace."³⁴ Clearly, the conventional wisdom was that contested cram down hearings were to be avoided.

The expense of litigating the value of the company was cited by many interviewees as a reason for allowing equity to share in the distribution.³⁵ In most of these cases, however, the expense of litigating the issue of valuation probably would have been only a fraction of the distribution made to equity. To be entitled to cram down a plan that provided no share to equity, the proponents would only have had to prove that no creditor class was receiving more than its valid claims. As noted above, in most of these cases, this was obvious to all concerned.

There is no reason to believe that it would have been difficult to prove this obvious fact had the plan proponents chosen to do so. In three of the forty-three cases in our study (7%), the debtor pushed a plan to confirmation despite the fact that an active, aggressive group of equity holders opposed it. From the creditors' point of view, Evans Products presented the most difficult valuation situation—a sprawling corporate group with numerous subsidiaries bordering on solvency.³⁶ When bargaining broke down between the creditors and Victor Posner, the controlling shareholder, the

³⁴ A similar view was reflected in one interviewee's report that the distribution was the product of the new investor's "business philosophy" of avoiding "confrontation."

³⁵ See also Broude, *supra* note 15, at 454 ("Valuation of the company is something that sophisticated participants in any significant chapter 11 reorganization avidly desire to avoid."); Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1125 (1985) ("Confirming a plan over the dissent of a class of stockholders requires what may be the most difficult kind of valuation: the prediction of earnings.").

³⁶ Though the holders of relatively small claims against the parent company recovered only 26.5 cents per dollar, see *supra* Table III following note 33, all creditors of corporations in the Evans Products group recovered an average of 80.9 cents on each dollar of their claims.

creditors withdrew a previous offer to the shareholders worth approximately \$18 million and proposed a plan that provided for no distribution to equity. The creditors then pushed the zero payment plan to a contested confirmation hearing. The court scheduled the hearing for a single day and concluded it in that time. Expert testimony was heard from each side regarding the values of the various securities that would be issued pursuant to the plan. The court, ruling that none of the twenty-one classes of creditors were receiving more than full payment, crammed the zero payment plan down against the shareholders. The decision was affirmed on the shareholders' appeal.³⁷

In two other cases, Manville and HRT, debtors pushed plans to confirmation despite opposition by active, aggressive equity committees. In both cases, the defense crumbled prior to the confirmation hearing, and the plan was crammed down without opposition. The Manville court disbanded the equity committee and refused to appoint a replacement committee. Stripped of his client, the lawyer for the equity committee resigned just prior to the confirmation hearing.³⁸ At the hearing, which lasted less than a day, the court valued the company on the basis of uncontested evidence presented by the debtor. Although the company was arguably solvent,³⁹ and bank and trade creditors received postpetition interest, and the court determined that the company was insolvent and crammed the plan down against shareholders.

³⁷ See *In re Evans Products, Co.*, 65 Bankr. 31 (Bankr. S.D. Fla. 1986). Victor Posner, the majority shareholder, controlled management and was quite unpopular with creditors. The equity committee, representing shareholders other than Posner, accepted the creditors' committee's original plan, but Posner, who held enough shares to block approval, refused to go along. It is a speculative matter whether the court, in the absence of these special facts, would have been so amenable to cram down after such a limited evidentiary hearing. In principle, however, there is no reason why a court should not rely on opinion evidence from investment bankers as a basis for confirming a plan that provides equity with nothing.

³⁸ The lawyer had a conflict of interest because the equity committee represented both preferred and common shareholders and preferred shareholders favored the plan while common shareholders opposed it. Negotiations to resolve the conflict were unsuccessful.

³⁹ During plan negotiations, Manville was considered by the participants to be solvent. On that basis, the trade and commercial creditors negotiated provisions of the plan under which they would be paid pendency interest. By the time of confirmation, the company's situation had deteriorated and the parties considered the company insolvent even though they did not renegotiate the plan. That conclusion, however, depended upon a number of assumptions which might have been (but were not) attacked in the confirmation hearing.

In HRT, the debtor was obviously insolvent. The equity committee opposed the sale of a 55% interest in the company at what they believed to be an inadequate price, apparently on the theory that a larger distribution could be made to equity if a better price were obtained, even though at any plausible sale price the creditors would still receive less than full payment. The committee chose neither to appear nor to submit evidence at the confirmation hearing,⁴⁰ and the plan was confirmed after a short hearing at which the debtor's expert testified that no creditor class would receive more than full payment.

In several other cases, plans under which shareholders received nothing were crammed down against unrepresented equity holders. In these cases, as revealed in Table III, no equity committee was appointed, no equity representative appeared in opposition to cram down, and the confirmation hearings were inevitably brief. Cram down was necessary in these cases because when a class receives nothing under a plan, it is deemed to object, and no vote of class members is taken.⁴¹

While several of these cases have their own peculiar facts that make generalizations difficult, taken together they suggest that in the case of a clearly insolvent company, an attempt to cram down a plan against equity is not likely to result in litigation expense nearly as great as the distributions offered to equity in most of the cases. The cram down hearing did not exceed one day in any of the eleven cases in our study. This circumstance suggests that while the direct expense of litigating to cram down may be a factor that contributed to the distributions to equity, it was not a predominant one.⁴²

⁴⁰ Equity would not have been able to defeat the plan merely by proving that the sale price was inadequate. Under the absolute priority rule, unsecured creditors, not equity holders, would have been entitled to the benefit of a higher price. To defeat the plan at the cram down hearing, equity would have had to prove that sale at an adequate price would have yielded enough to pay creditors in full and leave more for equity than they were to receive under the current plan. Equity could not have met this burden. The equity committee had nonetheless pursued its objection to the proposed sale at the hearing to approve the disclosure statement respecting the plan that was confirmed. After failing to persuade the judge not to circulate the plan for a vote, the committee concluded that further objection would have been futile.

⁴¹ See 11 U.S.C. § 1126(g) (1982).

⁴² We anticipate that in a cram down proceeding involving a clearly insolvent company, a court would make the requisite findings based on opinion testimony from investment bankers. The court would be willing to enter a confirmation order for a plan providing nothing to equity, based on a finding that the total value of distributions to creditors is clearly less than the creditors' claims. The court would find it

Considerations of timing and of the potential ability of active equity interests to cause delay were often cited as important reasons why creditor interests agreed to distributions to equity. Delay of uncertain duration while either confirmation or collateral issues were litigated could cause business losses far greater than equity's share of the distribution. For example, in *Braniff*, *HRT*, and *Saxon*, the essence of each plan was a sale of the business to a third party. Delay might have caused the buyer to back out of the deal, depriving the creditors of the substantial cash payments they expected if the plan was approved and the sale consummated. Delay also tends to increase the expenses of administration.⁴³

Additionally, negotiators may be pressured into quick agreement by other factors. In *Crystal Oil* and *Oxoco*, for example, debtors were rushing to obtain confirmation of their plans prior to the effective date of a major tax change. In *Wickes* and *Salant*, ambitious CEOs were anxious for their companies, laden with net operating losses (NOLs), to emerge from chapter 11 so they could begin acquiring other companies. The acquisitions would enable the companies to make use of the NOLs, as well as realizing the CEOs' ambitions of expanding the companies in size.⁴⁴

unnecessary to precisely value the creditor distributions. Commentators have noted that a precise valuation would be very time consuming. See *supra* note 35. The view expressed here is not stated elsewhere in the literature, but a similar point is made about an analogous issue. Even if a class votes in favor of a plan, when an individual creditor votes against the plan it can only be confirmed if the court finds that the dissenting creditor will receive at least as much as the creditor would receive in a liquidation. See *supra* note 11. A noted practitioner has observed that this statutory requirement for a valuation—applicable to nearly all confirmations, not just cram downs—rarely presents a problem because when “distributions under the plan clearly exceed the . . . minimum . . . no formal valuation is necessary.” Fortgang & Mayer, *supra* note 35, at 1106 n.203.

⁴³ Knowledgeable observers have noted a strong relationship between the length of time a chapter 11 case remains open and the total expenses of administration. New York Bankruptcy Judge Burton Lifland made this point as a member of the panel of the Debtors' and Creditors' Rights Section of the Association of American Law Schools at the Association's annual meeting on January 5, 1990. These expenses of administration, however, represent costs that a company would incur whether in or out of bankruptcy. It is only the “extra” administration costs that should be included in any cost-benefit calculation respecting a delay.

⁴⁴ Contrary to many first impressions, the fact that unsecured creditors do not receive interest during the pendency of a chapter 11 proceeding is not necessarily a reason for creditors to be adverse to delay. Certainly creditors can invest their distributions as soon as they receive them, but while the assets remain in the debtor's possession they can also be invested, with the proceeds used in an insolvency case to enhance the ultimate distribution to creditors. In these circumstances, the non-payment of interest should make creditors adverse to delay only if they believe they can invest

Although timing concerns undoubtedly account for some of the concessions made to equity interests,⁴⁵ we doubt that equity holders in the large majority of the cases studied had much ability to delay confirmation. Once a plan has been drafted and filed, it generally takes three to five months to obtain an order approving the disclosure statement, to offer creditors and equity holders the opportunity to review the disclosure statement and vote on the plan, and then to bring the matter before the court for a confirmation hearing. These steps are required whether or not the representatives of equity holders consent to the plan. While each may require a little extra time if the case is contested, the difference is not likely to be great and may be partly or completely offset by the time saved by excluding the representatives of equity from plan negotiations, an exclusion that could be effected if an early decision was made to freeze out equity.

Nor are the representatives of equity likely to be able to cause significant delay by litigating collateral matters, such as whether bank debt should be subordinated.⁴⁶ Most collateral issues would not affect the distribution to equity, and equity would lack standing to raise them.⁴⁷ Furthermore, bankruptcy procedure is highly flexible and the bankruptcy courts frequently schedule urgent matters for hearing on relatively short notice. If collateral litigation were likely to delay confirmation of the plan in a major case, a bankruptcy court could, and most probably would, bring the litigation to a speedy conclusion.

Thus, while we agree that both direct litigation costs and fear of delay are factors that encourage plan proponents to include equity

the assets more productively than the debtor.

⁴⁵ In *Wickes*, for example, the equity committee threatened to litigate a lender liability claim against bank claimants. This threat may have partly accounted for a last minute agreement to augment the distribution to equity previously proposed by management and creditors.

⁴⁶ See 11 U.S.C. § 510(c) (1988); Hass, *Insights in Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders*, 135 U. PA. L. REV. 1321, 1330 n.34 (1987).

⁴⁷ See, e.g., *In re Evans Products, Co.*, 65 Bankr. 870, 874 (Bankr. S.D. Fla. 1986) (holding that appellants lacked standing to appeal those parts of the reorganization plan that did not directly affect their interests); *Holywell Corp. v. Bank of New York*, 59 Bankr. 340, 349-50 (Bankr. S.D. Fla. 1986) (finding that appellants lacked standing to attack the validity of the overall reorganization plan because they were not injured parties); *In re Sweetwater*, 57 Bankr. 743, 746 (Bankr. D. Utah 1985) (stating that "an appellant who is appealing from a Bankruptcy Court order confirming a plan of reorganization may challenge only those parts of the plan that directly, adversely, and pecuniarily affect the appellant").

in the distributions made by even clearly insolvent companies, we believe that these factors are insufficient to explain the size of the distributions to equity. We are persuaded that there are other more important reasons why a distribution to equity has become the norm in reorganizations in which creditors receive more than approximately 15% of their claims.

As has been reported in other studies,⁴⁸ in the reorganization cases of small businesses in which managers are also the principal shareholders, equity frequently dominates the bargain to such an extent that the absolute priority rule is virtually stood on its head. In such cases, the claims of creditors are compromised, but shareholder-managers usually retain their shares without dilution. The dependence of the business upon the continuing services of the shareholder-manager is the primary bargaining leverage used to accomplish this feat.⁴⁹ The dependence may result from the need to maintain personal relations with suppliers, customers, and key employees, the need for unique services that only the shareholder-manager can provide, or from the shareholder-manager's willingness to work for less than the economy generally pays for such effort.⁵⁰ Unsecured creditors are willing to waive their right to priority in order to create an incentive for the shareholder-manager to continue her participation in the business. They realize that without such participation, the business will fail, and the assets will be liquidated for the benefit of the secured creditors, leaving nothing for the unsecured creditors.

The need for continuing cooperation from particular managers provided substantial leverage for the shareholder class in only one of the large reorganization cases included in our study.⁵¹ In

⁴⁸ See Kerkman, *The Debtor in Full Control: A Case For Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 165-83 (1987) (discussing creditors' inability to effectively negotiate their own treatment under chapter 11 reorganization plans); LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 247, 266-69 (1983) (finding that in chapter 11 reorganization proceedings creditors' interests are often compromised while debtor-managers' interests remain unimpaired); see also EXECUTIVE OFFICE FOR THE U.S. TRUSTEES, U.S. DEP'T OF JUSTICE, AN EVALUATION OF THE U.S. TRUSTEE PILOT PROGRAM FOR BANKRUPTCY ADMINISTRATION 39-88, 297-302 (1983) (evaluating the U.S. Trustee pilot program in chapter 11 case administration).

⁴⁹ See LoPucki, *supra* note 48, at 256.

⁵⁰ See J.K. GALBRAITH, *ECONOMICS AND THE PUBLIC PURPOSE* 71-77 (1973) (describing such willingness to work as "self-exploitation").

⁵¹ In Dresco, management's leverage was the dominant factor in bringing about a very substantial deviation from the absolute priority rule. The Pheasy group were major shareholders. During the reorganization proceedings, this group was forced out of the

general, particular managers of large companies are not as important to the companies' survival as are the managers of small companies. Their bargaining leverage does not derive from irreplaceable contacts with customers and suppliers or knowledge indispensable to the operation of the business. Although they do offer managerial skills and abilities, for the large company there is likely to be a pool of available talent willing to replace a dismissed manager. In our study, managers who resigned were usually quickly replaced by new managers, either from the lower ranks of the debtor company or from an active market in executive talent.

Of course, that did not mean that managers of the companies in our study had no leverage at all. Changes in management are disruptive; new management needs time to become informed, and that tends to delay the reorganization effort. Consequently, managers who had good credentials, demonstrated success, and had the confidence of the various parties to the reorganization were regarded as important assets. The possibility that they might quit gave them leverage in dealing with creditors. It is probable that management also derived a bargaining advantage in dealing with creditors from their superior access to information about the business and from their ability either to cooperate with or to resist the creditors' efforts to become informed as the reorganization proceeded. Management also gained leverage from the extraordinary powers granted to the "debtor-in-possession"⁵² under the Bankruptcy Code, probably most importantly the exclusive power to propose a plan during the first 120 days of the case and during such extensions as the court allows.⁵³

The leverage available to managers in large reorganization cases is not necessarily exercised in favor of shareholders. In the large majority of the cases in our study, managers and shareholders were distinct groups. While managers usually owned some shares, their self-interest could normally be better served, and at a lower cost to creditors, in ways other than enhancing the distribution to share-

day-to-day management of production, but still actively participated in marketing for the company. In addition, they still retained essential customer contacts without which the company might not have been able to survive. They used their resulting leverage to negotiate a \$6.5 million distribution to equity, while the unsecured creditors had to settle for \$4.5 million, less than 12% of their claims.

⁵² Formally, the "debtor-in-possession" is the debtor corporation; as a practical matter, it is the incumbent managers.

⁵³ See 11 U.S.C. § 1121 (1988). Extensions of exclusivity were typical in our sample cases. See *supra* note 6.

holders: they could seek higher salaries, bonuses, stock, or stock options.⁵⁴ Alternatively, they could seek to increase the size of the company, to improve its liquidity, or to take it out of the reorganization proceeding sooner.⁵⁵ Of course, this discussion assumes that management is immune from normal corporate governance processes, which might protect against such opportunism. In fact, as discussed later in this Article, in a few cases shareholders were able to utilize corporate governance processes to check management behavior, but in others a court prevented shareholders from doing so.⁵⁶

The questions of how much leverage management has in these large cases and in whose interest it is used are questions of such importance and complexity that we have reserved them for a separate article based on this study. For now, suffice it to note that in many of the reorganization plan negotiations studied, management did propose that equity share in the distribution, and creditors acquiesced. The view of some interviewees was that management had a duty to use its leverage to ensure that equity shared in the distribution. As one experienced practitioner put it: "If management is satisfactory to creditors and the creditors want management to continue, they must let management give something to equity." We have concluded that this protection by managers was an important reason why such distributions were made in several of the cases in our study.⁵⁷

Management's ability to obtain a distribution for equity was enhanced when the amount to be received by equity was small in relation to the amounts to be distributed to unsecured creditors, as

⁵⁴ To put it more crassly, if creditors decide to offer management a "bribe" in order to secure a reorganization plan to their liking, it is much cheaper to offer that "bribe" in the form of advantageous employment terms (including generous severance benefits—a "golden parachute") than in the form of a distribution to the equity class, only a small part of which will get to management. See, e.g., HRT, Inc. (managers sought golden parachutes as part of a plan for arms-length sale of the business); McLouth Steel, Inc. (new managers sought bonuses a few months after they were hired); Wickes Companies, Inc. (turnaround managers sought improved employment contracts during plan negotiations).

⁵⁵ In Wickes Companies and Salant, strong incumbent managers took their companies out of chapter 11 at the earliest possible dates, in part to satisfy a personal preference to begin acquisition programs that would expand their companies in size.

⁵⁶ See *infra* text accompanying notes 79-80. It is now settled that the bankruptcy court has some discretion to enjoin shareholder meetings during the course of a chapter 11 proceeding. See *In re Johns-Manville Corp.*, 801 F.2d 60, 64-69 (2d Cir. 1986).

⁵⁷ In other cases, however, management made no effort to benefit shareholders, instead, it employed its leverage for other purposes.

it normally was.⁵⁸ The impact of allowing equity to share was spread among numerous unsecured creditors. Many interviewees considered this impact spreading to be an important explanation for the creditors' decision to permit equity to share in the distribution. They pointed out that no individual creditor would gain enough by freezing out equity to make it profitable to invest its own resources in resisting the distribution to equity proposed by management. The creditors' committee may also be unwilling to go to war over an issue that is not pushed by any one of its constituents. While the unsecured creditors' committee is supposed to represent class interests, which are substantial when the proposed equity distribution is valued in absolute dollar terms,⁵⁹ it may be primarily concerned with issues considered to be even more important, such as the timing of the case or what proportion of cash, debt instruments, and shares the creditors will receive.

In a few of the cases in our study, interviewees reported that allowing equity to share in the distribution helped to maintain a market for the company's equity securities. In Anglo Energy, for example, there were only eight creditors, all large banks with large claims.⁶⁰ By allowing shareholders to retain a part of the equity in the reorganized company, the creditors, who received the major portion of the new shares, sought to ensure that the new shares would be publicly traded and thereby enhanced in value.⁶¹

It was suggested in some of our interviews that a company has public relations reasons to prefer a consensual plan. Most reorganizing companies have been the subject of dissension and controversy. If the various interests visibly "make peace," it may help to convince customers, suppliers, and most importantly potential future lenders that the company's problems have been resolved to everyone's satisfaction and that the company has rebounded from its crisis.

To what we suspect will be the surprise of some readers, taxes were not an important reason for distributions to equity in our

⁵⁸ See *supra* Table III following note 33.

⁵⁹ As Table III indicates, the distribution typically measures in the millions of dollars. See *id.*

⁶⁰ In this case, only the first level subsidiary filed for bankruptcy. All the company's operations were conducted through lower level subsidiaries, which remained solvent. Consequently, there were no trade creditors, only lenders, involved in this bankruptcy.

⁶¹ Tacoma Boatbuilding and Crystal Oil were other cases in which we believe that this motive of maintaining a public market for reorganization securities partly explains the distribution to equity.

cases. The preservation of net operating loss carryovers (NOLs) for future use is a central tax concern in large chapter 11 proceedings. These tax benefits; however, were rarely affected by whether or not equity shared in the distribution.⁶²

⁶² There are two principal ways in which NOLs can be lost in a bankruptcy reorganization: (1) if the restructuring of the corporate entity results in recognition of income that absorbs NOLs or, in the case of income from debt cancellation, direct reduction of NOLs; and (2) if provisions limiting the transferability of NOLs apply to prevent the restructured corporation from using the NOLs built up before the restructuring.

The recognition of income from debt cancellation can be avoided, however, under the well established stock-for-debt exception. This is an exception, applicable in all bankruptcy cases or outside bankruptcy when the debtor corporation is insolvent, to the general rule that cancellation of debt results in income that is either taxable or reduces tax attributes such as NOLs. See I.R.C. § 108 (1988). This exception creates a tax incentive for the debtor to distribute shares of the reorganized company to creditors of the old company. Indeed, it is important that stock exchanged for debt be more than "nominal or token" shares, or the exception may not apply. See I.R.C. § 108(e)(8)(A) (1988); Shakow, *United States Steel and Kirby Lumber: Another View*, 42 TAX NOTES 1371, 1373 (1989).

Avoiding income to the debtor corporation in a bankruptcy reorganization because of what is deemed a transfer of assets from one corporate entity to another is not difficult. Most reorganizations will qualify as "E" reorganizations under corporate tax laws, which exempts the transaction from such tax consequences. Tax law's "continuity of interest" rule, requiring that old security holders (including long term debt holders) maintain a substantial interest in the new corporation, has no applicability to an "E" reorganization.

The major legal problem faced by a reorganizing corporation with regard to preservation of NOLs is presented by I.R.C. § 382 (1988). This section was completely rewritten in 1986. With respect to corporations in chapter 11, the new rules apply only to corporations that filed bankruptcy after August 14, 1986 and had a plan confirmed on or after January 1, 1987. Hence, the "old" rules apply to most of the companies in our study.

Under the old rules, if the only creditors receiving shares held long term debt (roughly five years or more in duration), the reorganization was exempt from § 382. Trade and bank creditors generally held short term debt, however. Where they received shares, to avoid application of old § 382 (which eliminated NOLs entirely) it was necessary to ensure either that no group of ten such creditors received as much as 50% of the reorganized company's stock or that the company did not change its businesses over a time period that varied from case to case but was generally between one and two years. Generally it was possible to take advantage of one or the other qualification for avoiding application of § 382, and in neither case was it necessary to give any reorganization shares to old equity. In a rare case, where the creditor class was small or dominated by one large creditor, it might have been desirable to distribute new shares to old equity in order to avoid distributing 50% of the shares to any group of ten creditors.

Under the post-1986 rules, § 382 will often limit the use of NOLs after a bankruptcy reorganization. The old ways for avoiding § 382 no longer exist. In some circumstances, however, it will be possible to avoid § 382 by giving just over 50% of the reorganization shares to old shareholders, providing the distribution is accompanied by a three year transfer restriction on the new shares. Moreover, there is a special elective

Even when considered together, we do not think that the factors of litigation expense, timing, managerial preferences, loss spreading, public relations concerns, and the making of markets for the company's securities adequately explain the size of the payments made to shareholders in the Table III cases. On the basis of our many interviews with attorneys, we are convinced that these payments are not negotiated solely in the shadow of adjudication. Rather, the outcomes of these negotiations are significantly determined by the social norms of the legal culture which has grown up around these kinds of cases. The highly intermediated nature of the chapter 11 process provides bankruptcy lawyers, bankruptcy judges, turnaround managers, and creditor representatives with a considerable degree of independence from their constituencies.

In describing the chapter 11 process as "intermediated," we mean that reorganization plans are not directly negotiated by the parties in interest, but rather by intermediaries functioning as the parties' representatives. The effects of intermediation are compounded by perplexing layers of agency. For example, a public bondholder may be represented in the chapter 11 case by an indenture trustee, which is usually the trust department of a bank. The bank may retain a member of a private law firm to conduct the representation. If the indenture trustee is appointed to membership on the unsecured creditors' committee, the lawyer may be the one who attends the meetings. The committee will retain a bankruptcy lawyer to represent itself in negotiations with the debtor and the representatives of shareholders.

We observed many variations in the agency structures that pervade large chapter 11 proceedings. In some cases there were subcommittees or executive committees of creditors' committees and there was often more than one committee representing different kinds of creditors. Some committees undertook to represent their constituents, while others would be better described

rule for corporations in bankruptcy that will often be the most desirable option available for coping with § 382. To qualify for this special election, it is necessary that 50% of the post-confirmation shares be distributed to old equity and "historic" creditors, defined as creditors who acquired their claims in the ordinary course of business or held them for 18 months preceding filing. *See* I.R.C. § 382(l)(5) (1988). (A pending proposed treasury regulation will, if adopted, impose a "continuity of business" requirement on § 382(l)(5) reorganizations, thereby limiting their desirability. 55 Fed. Reg. 33,137 (1990) (to be codified at 26 C.F.R. pt. 1) (proposed Aug. 13, 1990)). For these reasons, under the new § 382 there will sometimes be a tax incentive in chapter 11 reorganizations to allow old equity to retain shares in the reorganized company.

as forums in which their constituents struggled for power. Some committees spoke through their attorneys, others spoke through individual committee members, and still others spoke through some combination of the two. Most of the committees represented hundreds or thousands of constituents and very few were in a position to consult with or poll a significant number of their constituents.

Although creditors' committees represented all of the unsecured creditors, typically the membership of the committees consisted only of large creditors, and the committees were often dominated by bank creditors. Committee attorneys, who often made a business of representing creditors' committees, may have been responsive primarily to the interests of the largest creditors. Ultimately, all constituents could vote on the proposed plan of reorganization, but the votes were typically mere formalities. Individual creditors were rarely in a position to understand, much less question, the deals entered into on their behalf.

The representation of shareholders was also highly intermediated. We were often told in interviews that management represented shareholder interests, but the link is indirect. In large chapter 11 proceedings, shareholders might or might not be able to elect a board of directors,⁶³ who then might or might not ensure that the managers, or their lawyers, speak for shareholder interests in plan negotiations. In addition, while shareholders were usually represented by an equity committee, the committee was usually composed of a few small shareholders because they were the only ones willing to serve.⁶⁴ The committee, in turn, hired a lawyer to

⁶³ See *In re Johns-Manville Corp.*, 801 F.2d 60, 69 (2d Cir. 1986). The question of when normal corporate governance processes can be altered for a firm in bankruptcy will be discussed extensively in another article based on this research project. That article will focus particularly on the role of management in large chapter 11 proceedings.

⁶⁴ Equity committees often fail to include major shareholders, who are concerned about having to stop trading in the company's stock because of access to inside information. The owners of shares of only nominal value or "gadflies" may be able to form the equity committee as a consequence, and the intensity of their interest in the proceeding is likely to be a function of their sense of duty or intellectual interest rather than the amount of money they have at stake. There are indications that since the period covered by our study, the reluctance of large institutional shareholders to serve on committees may be dissipating. See Parker, *Investors Gain Confidence in Activist Roles*, PENSION & INVESTMENT AGE, April 4, 1988, at 3.

conduct the negotiations. Sometimes the equity committee met regularly to provide guidance to the lawyer; at other times the lawyer negotiated with little guidance from the client.

The intermediaries who negotiated reorganization plans were not only representatives of the parties in interest, but also members of professions, of independent firms, and of the bankruptcy community. They sometimes served interests related to these other roles. For example, the lawyers who appeared in these cases were mostly private practitioners who expected or hoped to be active "repeat players" in similar cases in the future. In our study of forty-three cases, fifteen firms obtained nearly half of the appointments as principal attorney for the debtor, creditors' committee, or equity committee.⁶⁵ These lawyers were likely to know the other lawyers in the case, by reputation if not personally, and they expected that they would be involved in other cases with them.⁶⁶

We concluded that the lawyers in the cases we studied had an incentive to be concerned not only with the welfare of their clients but also with their relationships to each other.⁶⁷ Lawyers who act unconventionally in a particular case may find it difficult to negotiate effectively in future cases with the other lawyers. Moreover, the other lawyers are likely to form and express opinions about the quality of the lawyer's representation, and these opinions may influence whether the lawyer obtains future clients.⁶⁸ For the

⁶⁵ There were 111 representations by a law firm as principal lawyer for the debtor, creditors' committee, or equity committee. Fifty-three of these representations, or 48%, were by firms that made more than one representation of this nature in a case in our study. These multiple representations were made by a total of fifteen firms. The significance of this statistic is enhanced by the custom that key negotiations usually were conducted by the head of the firm's bankruptcy department.

⁶⁶ See MacDonald & McLeod, *Pictures Are Worth a Thousand Words: Understanding the Chapter 11 Process Through Models and Simulations* 25 (1989) (discussion draft on file with authors) (estimating the size of the group of chapter 11 lawyers routinely handling large cases as about 200-300 lawyers); see also *id.* at 107 n.116 (indicating that rapid growth in the number of practitioners is putting great stress on old networks).

⁶⁷ The position of attorney for the creditors' committee in large cases is lucrative and highly coveted. We suspect that once one has landed the job, the pressure not to make a mistake—or not to appear to—must be enormous. The safest course is to stick to tradition, and in large reorganization cases the tradition is a consensual plan. This practice is another reason why intermediaries may be so partial to consensual plans.

⁶⁸ Social norms typically are enforced by ostracizing violators and these norms are no exception. Some equity committees and subordinate debt holders were represented by lawyers who did not adhere to the norms. Typically, these lawyers were retained by clients who bought securities at a substantial discount after the debtor was in bankruptcy. They raised technical legal issues which threatened to disrupt the flow of the proceedings and sought better treatment for their clients than was provided under

most part in a chapter 11 proceeding, an attorney's colleagues will expect an effort to reach a consensual plan. In this context, the impracticality of cram down can be both a useful myth and a self-fulfilling prophecy. To the extent that clients believe cram down to be impossible, they avoid or discharge lawyers who might attempt it, thereby enforcing the norm in favor of consensual plans and undermining lawyers who might be inclined to attempt a cram down.

The belief that reorganization can best be accomplished through consensual plans is also shared by many bankruptcy judges. Those judges can discourage litigation and encourage bargaining to a consensual plan through a variety of means. When plan negotiations in the Anglo Energy case seemed to be deadlocked, the judge stopped approving interim payment of fees to the attorneys for both the debtor and the creditors' committee. When the equity committee in the Manville case threatened to upset a tentative settlement reached among all other major interests in the case, the judge disbanded the committee. Probably the most important method, however, concerns the extension of "exclusivity," the period during which the debtor has the exclusive right to file a plan. So long as the debtor has the exclusive right to file a plan and does not do so, it is impossible for creditors or shareholders to litigate to a resolution of the case. Some judges extend exclusivity only a few months at a time⁶⁹ and use the hearings on successive requests for extension as opportunities to monitor the progress of negotiations and the positions of the parties. When the judge in the Texaco bankruptcy came to believe that the debtor might be preventing agreement on a plan to which the other interests would subscribe, the judge's implication that he was prepared to remove exclusivity quickly led to an agreement.⁷⁰

the norms. In our interviews, the establishment lawyers who usually represented debtors and creditors' committees often expressed their dislike and their contempt for those lawyers and their clients, referring to them as "spoilors," "crazies," "bottom scrapers," "hold up artists," or "troublemakers." Some argued that exclusivity was necessary to protect the responsible parties in the case from such interference. While some of the outsiders achieved favorable results for their clients, from the attitudes expressed, it seems likely to us that establishment attorneys rarely went out of their way to make the outsiders look good, and indeed they might have acted collectively to make the outsiders look bad.

⁶⁹ See, e.g., *In re Pine Run Trust, Inc.*, 67 Bankr. 432, 435 (Bankr. E.D. Pa. 1986) (granting a 90 day extension).

⁷⁰ See Miller, *Texaco, Inc.—An Unexpected Debtor Making Appropriate Use of the Bankruptcy Code*, in EDUCATIONAL PROGRAM OF THE 62ND ANNUAL MEETING OF THE

The bargaining in these cases does not take place solely in the "shadow of the law." The outcome of bargaining is determined partly by the prospective results of an adjudication but also to a significant extent by an informal process by which intermediaries, partly independent of their constituents and significantly dependent upon each other, enforce a set of social and cultural norms within their own ranks. The combination of independence from those they represent and dependence on each other enables this group to act in its own self interest. That self interest appears to be, in significant part, to make the reorganization process function in a smooth, predictable manner. The mechanism for achieving that function, the consensual plan, is more costly because everyone at the bargaining table must be given a share. But that cost is widely shared among parties whose knowledge of the process and control over it is limited by the intermediation. An individual who held the entire creditor position in any of these cases might well have decided to attempt a contested cram down against equity,⁷¹ and we believe such an individual would usually have succeeded. Due importantly to the highly intermediated nature of creditors' positions in these cases, however, creditors have commonly allowed otherwise virtually powerless equity interests to share in the distribution.

B. *Why is Equity Sometimes Frozen out of the Distribution?*

Despite the pressures toward settlement, there were nine cases in which equity did not share in the distribution. Attorneys in those cases, with the exception of the Evans Products case, told us that equity was excluded because the debtors were insolvent and the equity interests were so far "underwater" that they clearly had no entitlement. Unsecured creditors in those cases recovered less than fourteen cents on the dollar. Only in the highly unusual circumstances of the Evans Products case did unsecured creditors achieve a substantial recovery without permitting equity holders a share.

The lawyers' explanation fails to account for the distribution to equity in Braniff, Oxoco, and Dreco—three other cases in which

NATIONAL CONFERENCE OF BANKRUPTCY JUDGES 5, 13-15 (1988).

⁷¹ Without the agreement of creditors to a distribution to equity, the only legally confirmable plan in such a case would be a plan that offered nothing to equity. If management would not propose such a plan, the creditors might attempt to replace them with management who would, or they might simply declare an impasse in the bargaining and seek to lift exclusivity.

creditors recovered less than fifteen cents on the dollar.⁷² An adequate explanation of the zero payment cases must also include lack of "presence at the bargaining table"; our data indicates that equity shares in the distribution when their interests are represented in the bargaining process, no matter how little creditors recover.

One way equity interests may be "present at the bargaining table" is through an official committee of equity holders. Column 6 of Table III indicates the presence or absence of such a committee in each of the cases. A comparison of columns 3 and 6 of that table reveals that, with the single exception of the Evans Products case, when an equity committee organized and retained counsel, equity shared in the distribution. Even in the Evans Products case, the creditors' committee at one time agreed to a plan under which equity would have received stock worth more than \$18 million, though the plan ultimately confirmed provided nothing for equity.⁷³ Thus, in every case in which an equity committee was appointed, creditors at least offered equity holders a share in the distribution, regardless of how far "underwater" the equity interests were.

In one of the low payout cases, Oxoco, and in several cases in which creditors received a only marginally greater amount, equity received a share of the distribution despite the absence of an equity committee. Based on our interviews with attorneys in the cases, we attribute most of these recoveries to management's advocacy of a distribution to equity. As indicated in the preceding section, if management holds out for a distribution to equity, it usually will succeed. Hence, equity can obtain "presence at the bargaining table" through representation by management.

Two of the nine cases in which equity received nothing, Seatrain Lines and Air Florida, further attest to the vulnerability of unrepresented equity interests. In those cases, the equity class was ostensibly offered a share in the distribution, and the requisite majorities of shareholders voted in favor of the plan, thereby avoiding the necessity of a cram down. In each of the cases, however, the distribution to equity was in fact worthless. It consisted of warrants to buy stock in the emerging company—but at

⁷² See *supra* Table III following note 33. Phoenix Steel, one of the cases that we could not value, was also a case in which creditors received less than 15 cents on the dollar, yet equity received something.

⁷³ The circumstances which led to this result are explained *supra* note 37 and accompanying text.

a price far above the reasonably projected market value of the stock.⁷⁴ There were no similar occurrences in any case in which an equity committee existed.

In five low payout cases in which equity did not have representation,⁷⁵ there were subordinated classes of creditors who were entitled to priority over equity. In several of these cases, the subdebt was as hopelessly underwater as the equity interests.⁷⁶ Nonetheless, in each case subdebt was permitted to share in the distribution. In fact, in none of the cases in our study was a class of subordinated creditors frozen out of the distribution.

We think the most important reason⁷⁷ why subordinated debt always received a distribution was its presence at the bargaining table in every case observed. Subdebt invariably was a debenture issue represented by an indenture trustee. Typically, this trustee was appointed to the unsecured creditors' committee. In some cases in our study, investors acquired substantial holdings in the subdebt and then participated in the case to protect their investment. Through the efforts of such investors, subordinated debt holders sometimes won the appointment of independent, official committees to represent their position. Even if subdebt holders did not obtain representation at the bargaining table in one of these ways, they did not go unrepresented. In every case except EPIC, an unsecured creditors' committee was appointed, organized, and represented by lawyers. Those committees and their lawyers had a fiduciary obligation to represent all unsecured creditors not otherwise represented, which necessarily included the subdebt.

⁷⁴ In the Air Florida case, for example, the warrants were to buy stock at \$2.40 a share. The disclosure statement gave no indication as to the value of the shares, which would not trade until after confirmation. The stock began trading at 10 cents a share. Participants in the negotiations were aware that the warrants were virtually worthless and expressed surprise that equity holders nevertheless voted in favor of the plan.

⁷⁵ Seatrain, Amarex, MFG, Nucorp, and Pizza Time.

⁷⁶ In some of the cases, legitimate legal questions arose about the validity of the subordination agreement. In Nucorp, for example, there was a relatively small amount of general unsecured debt. The major creditors were banks who claimed to be secured, and subdebt. Subdebt had plausible fraudulent conveyance and equitable subordination claims against the banks. The distribution to subdebt can be viewed as a compromise of those claims.

⁷⁷ Taxes may also explain distributions to subdebt. A general tax principle holds that discharge of indebtedness is income. The equity-for-debt exception preserves the corporation's NOLs by giving subdebt some reorganization securities. See *supra* note 62. This reason appears to have been determinative of the distribution to subdebt in MGF.

C. *How Much Does Equity Get?*

We could discern no pattern in the distribution amounts to shareholders in the cases of clearly insolvent companies. Although the data in Table III shows that equity is more likely to share in the distribution when creditors are recovering a larger percentage of their claims, it does not appear that equity's proportionate share of the distribution increases with the percentage recovered by creditors. This is consistent with what we were told in interviews. None of our interviewees described equity's share of the distribution as being the product of a financial calculation. Nor could they suggest any formula that would relate equity's share to the absolute priority rule, the percentages recovered by creditors, or other variables.

We believe equity's share of the distribution was determined by the bargaining leverage of the different parties and by their representatives' skill in exploiting that leverage. In a typical case, management proposed that a particular percentage of the shares of the new company go to equity. Aggressive representatives of equity frequently sought to increase that percentage, and were sometimes successful. A variety of tactics were employed. For example, if others wanted the case to move quickly, equity might threaten delay. Other tactics by equity included: combing through the financial affairs of the company looking for matters to litigate; bringing in prospective purchasers for the company who talked high prices even if they made no commitments; or threatening to oppose confirmation by presenting evidence on the issue of valuation. Creditors sometimes retaliated by threatening to cram down a zero payment plan.⁷⁸ Ultimately, the parties assessed the credibility of the various leverages, engaged in a fair amount of bluffing, and arrived at a figure.

A tactic that proved especially effective in increasing equity's leverage was to call a meeting of shareholders for the avowed purpose of ousting management and installing replacements who would propose a larger share for equity. For example, in Saxon Industries, all parties knew that the company was clearly insolvent. Early in the proceeding the parties reached a consensus to sell Saxon's assets to an outside buyer. The equity committee, repre-

⁷⁸ If continuation of the chapter 11 depended upon continued interim lending (called chapter financing), the creditors' bargaining position was strengthened since the creditors often provided this additional lending.

sented by a large, well-respected New York law firm, objected strenuously to the buyer selected by management and the creditors' committee. The committee unsuccessfully pressed these objections in the bankruptcy court. In parallel litigation in the Delaware state courts, however, the equity committee obtained an order requiring Saxon to hold a shareholders' meeting.⁷⁹ The committee immediately announced its intention to launch a proxy campaign to displace management. In response, the prospective buyer threatened to withdraw unless a consensual plan was quickly confirmed. Fearing that they would be unable to find another buyer at a comparable price, the creditors' committee and management offered to increase equity's distribution to nearly twice what had been previously offered. The offer was accepted, a consensual plan was quickly confirmed, and the shareholders' meeting was never held.⁸⁰

Among the most important changes during the 1980s in the reorganization process of large, publicly held companies was a dramatic improvement in the market for claims against such companies. While registered stocks and bonds of reorganizing companies have long been traded, today even the claims of bank creditors and suppliers trade actively.⁸¹

The purchasers typically are investors who believe they can make a profit by buying the claims and shares for less than they will yield after confirmation of a reorganization plan. Some of these investors buy substantial holdings in a particular creditor class. They then use those holdings to participate aggressively in the reorganization case, either as a committee member representing that class's position or as a holder of claims whose votes will be necessary if that class is to approve the plan. By acquiring a large amount of claims that will be exchanged for stock as part of the plan, an investor might even gain control of the emerging company.⁸²

⁷⁹ See *Saxon Indus. v. NKFV Partners*, 488 A.2d 1298, 1299 (Del. 1984).

⁸⁰ For an account of this case by the attorneys for the equity committee, see Radick & Blauner, *Shareholders, Unite!*, BARRONS, Apr. 14, 1986, at 22. Consistent with our thesis, the authors argue that equity will fare better in a reorganization plan if an equity committee is formed and it acts aggressively. See *id.* at 24.

⁸¹ Recently, a bankruptcy newsletter began quoting the "going rates" for trade debt in major cases. See *The Supplement*, TURNAROUNDS & WORKOUTS, Apr. 15, 1990, at 2. See generally Note, *Post-petition Trading in Chapter 11 Claims: A Call For Augmentation of Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 58 FORD. L. REV. 1053 (1990).

⁸² See Pauly, Friday & Adams, *Sifting Ashes on Wall Street*, NEWSWEEK, Sept. 4, 1989, at 42-43; Martin, *The None-Too-Genile Art of the 'Bankruptcy Boys'*, N.Y. Times, July 18, 1988, at D1, col. 4; Wallace, *Investors Await a Rash of Defaults*, N.Y. Times, Nov. 5, 1988,

The improvements in these markets means that there is an increased likelihood that a class of claims will obtain aggressive representation and thereby fully exploit its potential leverage in the bargaining process. If claims such as publicly held debentures are widely dispersed, no one holder may have the incentive to ensure that the interests of the class are fully asserted.⁸³ By aggregating the claims, an investor acquires an interest sufficient to warrant exploitation of the bargaining leverages of the class and the realization of its potential under the reorganization plan.

Saxon Industries provides an excellent example of this process. In that case, several debenture issues were outstanding at the time of bankruptcy. An investor purchased a majority position in two of these issues on the public market. After successfully moving for appointment of a separate committee to represent subdebt, the investor was appointed chair of that committee and proceeded to develop a plausible fraudulent conveyance claim against major bank creditors.⁸⁴ This claim was never litigated, but it provided the leverage enabling subdebt holders to receive a distribution of about 32% of their claims, while senior bank creditors only received about 45%. Of course, the investor made a considerable profit.

Similarly, in the Wilson Foods case, the debtor proposed in its initial reorganization plan to leave a bond issue unimpaired.⁸⁵ This treatment was disadvantageous to the bondholders because the

at 35, col. 3; Fortgang & Mayer, *Trading Claims and Taking Control of Corporations* in Chapter 11, at 1, 1-2 (Aug. 29, 1988) (unpublished monograph on file with the authors).

⁸³ In the case of publicly held debt, the indenture trustee could play this role. Indenture trustees are usually members of the relevant creditors' committees, though sometimes in a non-voting capacity. They vary considerably in their enthusiasm for aggressive bargaining, however. Many indenture trustees refuse to participate in the bargaining or to offer an opinion on any proposed plan, positing that their role is to ensure that the proceedings are formally correct and that the debenture holders themselves must vote to approve the financial deal offered. For a discussion of the role of indenture trustees in chapter 11 proceedings, see Dunham & Borowitz, *The Role of the Indenture Trustee in Reorganization Cases Under the Bankruptcy Code*, 102 *BANKING L.J.* 436 (1985).

⁸⁴ The claim was based on the merger of subsidiaries into the parent many years before filing. A subsidiary had issued the debentures; the claim was that but for the merger, the subsidiary would still be solvent and even subdebt would be fully paid. The merger enabled the bank creditors of the parent to claim, under the subordination clause, assets that would otherwise have gone to subdebt.

⁸⁵ To leave a claim "unimpaired" means that any defaults are cured and that the plan provides for payment of the claim according to its original contractual terms. In the case of a bond, interest and principal payments would be made as scheduled in the bond. See 11 U.S.C. § 1124 (1988).

bonds carried a very low rate of interest, while other creditors were being paid in full, including postpetition interest at a higher rate. Aggressive investors bought a position in the bonds, retained counsel, and argued that the debtor had breached a restrictive covenant in the bonds by granting security to a postpetition lender during the bankruptcy case. The debtor settled with the investors by increasing the interest rate on the bonds, substantially increasing their market value.

For a variety of reasons, the development of markets for the securities and claims against reorganizing firms has affected primarily creditor classes, particularly subdebt. Investors have shown much less interest in buying positions in the shares of reorganizing debtors and helping to exploit equity's bargaining position. One reason undoubtedly relates to the prospective value of the distributions to the equity interests in insolvent debtors. This value is often too small in absolute terms to justify the effort involved in evaluating the shares for purchase, let alone participating in the case. As shown in Table III, in most of these cases the entire equity interest ultimately recovered only a few million dollars. Moreover, according to a study completed before the time period we studied, the shares of firms about to file bankruptcy are often overpriced.⁸⁶ Undeveloped sources of bargaining leverage may also have been more common among creditor classes, particularly subdebt, than among equity classes. In the cases we studied, issues were raised with surprising regularity about ambiguity in subordination clauses or about transactions between parents and subsidiaries that were fraudulent as to particular debenture issues. If non-frivolous, such legal claims have value in negotiations. They do not, however, arise as frequently with respect to equity.⁸⁷

VI. THE TERMS OF SETTLEMENT: SOLVENT DEBTORS

Table IV(A) shows the values distributed to creditors and shareholders in the cases of solvent debtors. The second column of Table IV(A) shows the value available for distribution to unsecured creditors and shareholders as a percentage of the allowed claims owing to unsecured creditors at the time of the filing of the

⁸⁶ See E. ALTMAN, CORPORATE BANKRUPTCY IN AMERICA 139-40 (1971).

⁸⁷ One reason for this infrequency is that fraudulent conveyance and equitable subordination claims only benefit equity when they are large enough to give equity the right to participate in the distribution if the claims are sustained. See *supra* note 47 and accompanying text.

petition. In this column, a value of 100 indicates that the value available for distribution was equal to the amount of the claims. The number in column 2 is always at least 100 because only solvent companies are included on this table.

If these cases had been adjudicated and the court had given the distributions the same values we did, under the absolute priority rule creditors would have been entitled to one hundred cents on the dollar before equity became entitled to anything. The third and fourth columns show how the value available actually was apportioned between shareholders and creditors. Comparison of columns 2, 3, and 4 shows that when a company was only marginally solvent, equity holders were able to capture a substantial portion of the creditors' entitlements. Column 5 indicates the dollar amount of "shortfall" to creditors resulting from lack of enforcement of the absolute priority rule. Column 6 shows the total dollar value recovered by equity holders.

A. *Equitable Sharing Versus Absolute Priority*

Although there are few cases, we think the data supports the inference that there is an "equitable sharing" of the available values in the reorganizations of marginally solvent companies, with creditors taking the largest share. Based on our interviews, one important reason why equity interests fare relatively well in these cases is doubt about the value of the property being distributed to creditors. When companies are marginally solvent, creditors ordinarily receive substantial amounts of equity in the emerging company. The current shareholders can argue that the property being distributed to creditors is equal to the amounts of their claims and they can credibly threaten to litigate if creditors ask for more.

Shareholders, however, do not rely solely on valuation arguments to persuade creditors to "equitably share" the assets available for distribution. In AM International, Charter, and Lionel, the three cases in which sharing was most dramatic, management was effectively controlled by shareholders⁸⁸ and shielded by the exclusivity rule. This situation placed creditors in a difficult bargaining position. To enforce absolute priority through litigation,

⁸⁸ In the Lionel case, an aggressive equity committee won seats on the board by forcing the election of new directors during the bankruptcy proceedings. In Charter, the CEO was a relative of the controlling shareholder. In AM International, a 15% shareholder was on the historically active board of directors and was one of three members of the subcommittee that oversaw the bankruptcy proceeding.

creditors first would have had to persuade the court that exclusivity should be lifted, and then propose and win confirmation of their own plan. Even so, their own plan would not have been confirmable if it provided them with more than the full amounts of their claims, without interest during the pendency of the chapter 11 case.⁸⁹ Due to the loss of interest during the delay associated with later adjudication, this sum may have been worth less on a present value basis than the amount management offered in the plan that was confirmed. When management of a marginally solvent debtor is firmly in equity's camp, and particularly when pendency interest is unavailable, considerations of timing can be an especially important reason for creditor concessions to equity.⁹⁰

TABLE IV(A)

SOLVENT DEBTORS: DEVIATION FROM THE ABSOLUTE PRIORITY RULE^a

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Case Name	Cents per Dollar of Unsecured Claims Available	Cents per Dollar Paid to Unsecured Creditors	Cents Captured by Equity	Unsecured Creditor Shortfall (in millions)	Equity Holder Recovery (in millions)	Equity Committee?
AM Int'l	100.3	86.1	14.2	\$37.4	\$38.5	No
Charter ^b	104.1	86.3	17.8	58.2	91.2	Yes
Lionel	112.5	85.6	26.9	20.7	38.6	Yes
Manville ^c	131.0	125.3	5.7		132.9	Yes/No
Penn-Dixie ^d	134.6	96.8	37.8	.6	7.5	Yes
Revere ^e	136.6	92.7	43.9	11.1	83.7	Yes
StorageTek ^f	145.6	130.5	15.1		117.2	No
Smith Int'l	151.1	107.1	44.0		159.7	Yes
Salant	157.0	96.5	60.5	2.2	37.5	Yes
Wilson Foods ^g	205.9	104.7	101.2		59.6	No
Continental	262.1	114.3	147.8		441.7	No

^a Debtors were considered "solvent" if the total value distributed to unsecured creditors and shareholders under the plan exceeded the amount of the allowed unsecured claims. The "shortfall" to creditors is the total amount of allowed claims of unsecured creditors less the value of the distribution to unsecured creditors. In

⁸⁹ The availability of pendency interest under the Bankruptcy Code is discussed below. See *infra* text accompanying notes 96-102.

⁹⁰ Consistent with this explanation, the creditor representatives in the Charter and Lionel cases were aware they were receiving less than they would receive in an adjudication. In AM International, creditors also probably realized they were receiving less, but not as much less as our valuation indicates. Creditor representatives in AM International believed that the stock distributed to creditors was worth more than it sold for on our valuation date; a few weeks after confirmation it did sell for significantly more than on our valuation date.

a chapter 11 case, the amounts of prepetition claims are generally considered fixed as of the filing of the case. Under the absolute priority rule stated in 11 U.S.C. § 1129(b)(2)(B), unsecured creditors are entitled to priority only for the nominal amounts of their claims, not for the time value of those claims. Accordingly, in calculating this table, the values distributed to creditors and shareholders were discounted only to the date of confirmation of the plan, not to the date of the filing of the petition. As a result, the calculations in this table ignore the time value of the unsecured creditors' money during the pendency of the chapter 11 case. In Table IV(B), the cents paid per dollar of unsecured creditors' claims have been recalculated, discounting those values to the date of the filing of the petition in each case. Recoveries in excess of 100 cents on the dollar in Table IV(B) can be thought of as including "pendency" interest—that is, interest accruing during the pendency of the chapter 11 case.

^b In the Charter case, a major creditor contributed some extra capital and received a controlling block of shares. We have excluded this creditor's claim and distribution from our calculations concerning distributions to creditors because of uncertainty about what part of the distribution should be attributed to the new capital contributions and what part to the outstanding claims.

^c Our figures in the Manville case are based solely on the distributions to commercial and trade creditors; we excluded the asbestos health and property damage claims because both the amounts of the claims and the value of their distributions were highly speculative. There was an active equity committee in Manville, but it was disbanded by court order before confirmation.

^d In the Penn-Dixie Industries case, about half of the distributions made to unsecured creditors were made to creditors of a wholly owned subsidiary (Penn-Dixie Steel). These creditors received only about two-thirds of their claims. Because these creditors had no clear legal entitlement to amounts distributed to equity holders in the parent, we have not considered claims by and distributions to subsidiary creditors in our calculations. We have also excluded from our calculations the claims of and the sizable distributions made to the Pension Benefit Guaranty Corporation. Because the claim was disputed, we could not determine its amount.

^e In the Revere case, the debtor disputed the amounts of the claims of the two largest creditors. The settlement provided for a distribution to these creditors of \$35.7 million, but because we have no basis for determining the estimated amount of the "allowed" claim, we have excluded this distribution from our calculations.

^f In the Storage Technology case, a year delay occurred between basic approval of the reorganization plan and its effective date, primarily because of the need to resolve a contested IRS claim. During this period debt instruments and shares to be distributed to unsecured creditors appreciated considerably, resulting in an unintentional "overpayment" of creditors. The plan was not intended to pay creditors post-petition interest.

^g In the Wilson Foods case, debenture holders received less than full payment because they were subject to reinstatement and the interest rate was below the prevailing rates. The other unsecured creditors received full payment. The debenture issue was excluded from the calculations for this table.

In three of the cases in Table IV(A), Penn-Dixie, Revere, and Salant, the belief of the lawyers who negotiated the plan was that creditors were legally entitled to recover the full amounts of their claims, without interest from the date of the filing of the petition to the date the plan became effective (pendency interest), but with interest at the "market rate" after the effective date. Each settle-

ment was based upon that shared belief, and the plans are essentially in accordance with the absolute priority rule.

Nevertheless, in each of the three cases, the actual value of the creditors' recoveries, as of the day after confirmation of the plan, was somewhat less than the full amounts of the claims. Several factors were at work. First, debtors were able to "nibble" at creditors' recoveries by fixing the "effective date" of the plan a short period after the confirmation date. That enabled the debtors to retain the creditors' cash a little longer, without paying or accruing interest on it.⁹¹ Second, the rates of post-confirmation interest agreed to by the negotiators were below actual market rates.⁹² The use of relatively low "market" rates of interest in the adjudication of bankruptcy cases is customary,⁹³ and we think that the negotiated rates simply reflect this custom. Third, when stock and warrants were distributed to creditors, the parties may have guessed that these securities would have a slightly higher value upon distribution than the market actually assigned to them. Finally, in *Revere*, creditors were offered a choice between payment in full with a higher-than-market interest rate (14%) over a period of eleven to fourteen years, or sixty to sixty-five cents on the dollar in cash. Many of the trade creditors opted for the cash settlements, thus reducing the average recovery of the entire creditor group.⁹⁴

⁹¹ We valued creditors' recoveries as of the day after confirmation of the plan. Arguably, these valuations should have been as of the effective date of the plan. In a few cases, however, the effective date did not occur until long after confirmation, resulting in a diminution of creditors' recoveries that we thought should be reflected in our findings.

⁹² We believe that the "protocol" rates of interest we used to discount creditors' recoveries were low estimates of actual market rates. See *supra* note 28. We valued the creditors' recoveries at less than their face value because the market rates adopted by the negotiators were usually below even these protocol rates.

⁹³ See L. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS ¶ 11.6.2, at 412 (1985).

⁹⁴ This rather clever scheme for avoiding the absolute priority rule reflected some unusual bargaining leverages. In *Revere*, there was both an active equity committee and a major shareholder who held three seats on the board of directors. The latter circumstance was sufficient to insure management sympathy for a substantial distribution to equity. Furthermore, the same shareholder also owned a majority of the debenture issue. The option scheme enabled the company to pay the subordinated debentures virtually in full, to pay many of the trade creditors only a fraction of their claims, and to leave a substantial share for equity.

B. "Overpayments" to Creditors and the Influence of Claims for Pendency Interest

In four of the five cases in Table IV(A) in which creditors appear to have been paid more than the full amount of their claims, the creditors claimed they were entitled to "pendency interest," the interest that would accrue on creditors' claims from the date of the filing of the petition to the date of confirmation or the effective date of the plan. An understanding of the creditors' claims to pendency interest in these cases must begin with an examination of creditors' legal entitlement to pendency interest.⁹⁵

The Bankruptcy Code permits confirmation by cram down of a plan that provides unsecured creditors "property of a value, as of the effective date of the plan, equal to the allowed amount of [their] claim[s]." ⁹⁶ Another section of the Code excludes pendency interest from its definition of the "allowed amount" of a claim.⁹⁷ Since the cram down provisions provide the solution that would be reached if a case were resolved by adjudication, at first glance it would appear that there is no legal entitlement to pendency interest.

The so-called "best interests of creditors" test is, however, a prerequisite to confirmation of all plans, whether confirmed consensually or by cram down. This test requires that each creditor receive or retain under the plan "not less than the amount that [the creditor] would so receive or retain if the debtor were liquidated under chapter 7 of [the Bankruptcy Code]" ⁹⁸ If the liquidation of a debtor under chapter 7 generates proceeds in excess of what is needed to pay the allowed amount of all unsecured claims, the excess is used to pay interest on those claims at the "legal rate." ⁹⁹ Thus, creditors, who are not entitled to interest under the

⁹⁵ For statutory analyses similar to this examination, see Blum, *Treatment of Interest on Debtor Obligations in Reorganizations Under the Bankruptcy Code*, 50 U. CHI. L. REV. 430, 432 (1983); Fortgang & King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1149-60 (1981); Fortgang & Mayer, *supra* note 35, at 1109-10; Klee, *supra* note 13, at 234-37.

⁹⁶ 11 U.S.C. § 1129(b)(2)(B)(i) (1988). Under this section, the plan can also be crammed down if unsecured creditors receive less than the amount of their claim and junior interests receive nothing. See *id.* § 1129(b)(2)(B)(ii).

⁹⁷ See *id.* § 502(b)(2); see also *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 373 (1988) (holding that an undersecured creditor was not entitled to postpetition interest on its claim and noting the "general rule disallowing postpetition interest," with reference to 11 U.S.C. § 502(b)(2)).

⁹⁸ 11 U.S.C. § 1129(a)(7)(A)(ii) (1988).

⁹⁹ See *id.* § 726(a)(5). The "legal rate" is a highly ambiguous standard. It is generally

cram down provisions of Bankruptcy Code section 1129(b)(2)(B), will nevertheless be entitled to interest under the best interests of creditors test if the company could be liquidated under chapter 7 for enough to pay such interest.¹⁰⁰

Most of the literature on corporate reorganization assumes that the going concern values of companies usually exceed their liquidation values.¹⁰¹ A growing number of theorists, however, are questioning the conventional wisdom in this regard. These revisionists postulate that financial markets operate with virtual perfection and note that there is no a priori reason why a corporation cannot be liquidated under chapter 7 by selling it as a single entity to the highest bidder. If markets operate perfectly and the highest use of the company's assets is to continue the business, a buyer should be willing to pay an amount equal to the discounted future earnings of the business. In other words, the amount for which a company can be liquidated would be the same as its value would be assumed to be in a reorganization.¹⁰² If the revisionist

understood to be a reference to the law of the forum state concerning the rate of interest to be paid when a contract (for the payment of money with interest) does not specify a rate. Legal rate may also be a reference to the rate payable on a money judgment. In many states, the rate payable on a contract debt judgment is the rate specified under the contract. As a result, the "legal rate" of interest payable under chapter 7 may vary for every claim. See generally 4 COLLIER ON BANKRUPTCY ¶ 726.02[5] (L. King 15th ed. 1990) (describing the historical background of laws relating to postpetition interest). Some commentators have argued that the term "legal rate" should be interpreted as the rate stated in the underlying credit agreement (if an express rate is stated). See Fortgang & King, *supra* note 95, at 1151-53 (arguing that the statutory interest rate should apply only to parties who have not bargained for a different rate).

¹⁰⁰ See *In re San Joaquin Estates, Inc.*, 64 Bankr. 534, 536 (9th Cir. 1986) (noting that because similar creditors would receive interest in a chapter 7 case of this "very solvent" debtor, denying the unsecured creditors' motion for postpetition interest in the chapter 11 case was an abuse of discretion); *In re Boyer*, 90 Bankr. 200, 201 (Bankr. D.S.C. 1988) (noting that unsecured creditors who would have received full payment in a hypothetical chapter 7 case were entitled to pendency interest under the chapter 11 plan). There may be an exception to this requirement for postpetition interest where a creditor receives cash for the allowed amount of the claims and thus is "unimpaired." See Fortgang & King, *supra* note 95, at 1154-56. This circumstance did not occur in the cases reported in Table IV(A).

¹⁰¹ See, e.g., Fortgang & Mayer, *supra* note 35, at 1064-65 ("Going concern values generally exceed liquidation values Most asset 'liquidations' yield less than the value of the asset if retained by its current owner." (footnote omitted)); Trost, *supra* note 21, at 550 ("[T]he difference between the liquidation value and the going-concern value . . . could be very substantial" (parentheses omitted)).

¹⁰² Professor Baird, for example, has noted:

The ability investment bankers have shown to take large firms public (such as the Ford Motor Co. or Apple Computer) and the willingness of others to

arguments were accepted, under the best interests of creditors test the unsecured creditors of a company that proves solvent in chapter 11 reorganization would nearly always be entitled to pendency interest. Such a result obtains because they could have recovered interest if the company had been liquidated as a going concern under chapter 7.

Our interviewees were far more skeptical than the revisionists about the prospects for chapter 7 liquidations of the companies included in this study. Their view of the efficacy of markets lay somewhere between the dismal assumption that "[l]arge distressed corporations cannot be sold intact," cited by Professor Blum as one of the two main principles of bankruptcy reorganization,¹⁰³ and the revisionists' blithe assumptions of perfect markets.¹⁰⁴ The interviewees' view is also reflected in the "liquidation analyses" contained in many of the disclosure statements in our cases. These analyses, which contained the debtor's assertion as to what amounts would be distributed to creditors if the company were liquidated

acquire firms for huge sums (such as General Motors' multibillion dollar purchase of Hughes Aircraft) suggest that it is possible to sell the assets of even giant corporations to third-party buyers. In a world in which information can be gathered and communicated quickly and in which many entrepreneurs specialize in acquiring firms in distress, the practical obstacles (as opposed to the ones that are purely legal) seem quite surmountable.

Baird, *supra* note 1, at 141; see also Jackson & Scott, *supra* note 1, at 190 ("Going concern value . . . can be realized in a Chapter 7 liquidation by the simple expedient of a sale of the business to a third-party buyer. Furthermore, a third-party sale should generally be the optimal means of maximizing asset value.").

¹⁰³ The passage reads:

[T]wo main principles . . . constitute the framework for our existing system of reorganization. . . . The other [principle] is that the market value of a distressed business or its assets is not to govern the rights of those financially interested in the company. More particularly the creditors are not to foreclose and force a . . . valuation of assets at prevailing market prices. . . .

Abandonment or avoidance of the market in reorganizations has been explained in a number of ways. The most general explanation is that ordinarily no pertinent market exists. Large distressed corporations cannot be sold intact, and selling them piecemeal changes the commodity by destroying whatever value arises because a concern is a going thing and not a collection of assets.

Blum, *supra* note 29, at 566 (footnotes omitted).

¹⁰⁴ Under the current practice, a debtor whose business continues to operate virtually always files under chapter 11. As a result, it is very difficult to ascertain empirically whether companies could be sold intact in chapter 7 cases for the going concern value. In practice, cases are converted to chapter 7 only when it is clear that the business can no longer continue to operate profitably. Thereafter, the assets of the business are usually sold piecemeal. See LoPucki, *supra* note 48, at 263-66.

under chapter 7, were typically self-serving, since they were designed to convince creditors that they would receive more under the proposed plan than they would recover in a liquidation. Nevertheless, in each case the court approved the analyses as part of the disclosure statement, and in most cases¹⁰⁵ there was no suggestion that the creditors' representatives disagreed with them. Listed below are the estimated payments to unsecured creditors according to the liquidation analyses contained in the disclosure statements of some of the "solvent" companies listed in Table IV(A):

<i>Case</i>	<i>Estimated Payments</i>
AM International Charter	70 to 76 cents on the dollar
Lionel	"Little or nothing"
Manville	60 to 77 cents on the dollar
Revere	47 to 69 cents on the dollar
Salant	58 cents on the dollar
	73.4 cents on the dollar

Given the perception that liquidation under chapter 7 would have generated proceeds grossly insufficient to pay interest on unsecured creditors' claims, it is perhaps not surprising that the bargains in most of these cases were struck on the implicit assumption that unsecured creditors were not entitled to pendency interest.

Wilson Foods was the first case in our study, chronologically, in which the parties agreed to pay creditors postpetition interest. Pendency interest was set at 9.5%, which was only slightly below the market rate.¹⁰⁶ It was not until the fifth year of our study that there were other cases in which there was a consensus that the company probably could have been liquidated in chapter 7 for more than enough to pay interest on creditors' claims. The rate of pendency interest paid in the Continental Airlines and Smith International cases was less than prevailing contract or market rates, however, and reflected a negotiated compromise of the creditors' claims to pendency interest. In both cases the compromise was at

¹⁰⁵ The Manville case was an exception. In the early stages, the asbestos health claimants argued that the proceeds of a liquidation would be sufficient to pay them in full.

¹⁰⁶ In Wilson Foods, the debtor arguably had the right to leave a group of debenture holders unimpaired and pay the holders only the contract rate of interest. See 11 U.S.C. § 1124(1), (2)(D) (1988). Aggressive bondholders declared the bond issue in default and threatened to litigate their issues. The resulting compromise shortened the maturity date for the debentures, which enhanced their market value, but it still left the creditors with debentures worth substantially less than their face values. These bondholders also received pendency interest, though at a lesser rate.

least partly attributable to the aggressive representation of equity at the bargaining table.¹⁰⁷ Continental was a subsidiary of Texas Air, which owned 78% of its shares, controlled Continental's management, and aggressively represented the interests of shareholders. In Smith International, shareholders were represented by an effective, active equity committee. The committee was formed and dominated by professional investors who acquired substantial positions in Smith stock about the time of filing.¹⁰⁸ In both Continental Airlines and Smith International, the representatives of equity accepted the payment of some pendency interest, but their presence at the bargaining table, whether through an equity committee or through a management committed to their interests, appears to have been an important factor in forcing a compromise on the rates.

In the Manville case, equity holders challenged a plan that provided for the payment of pendency interest to unsecured bank and trade creditors.¹⁰⁹ The plan had been negotiated at a time when the parties thought the company was solvent, but assessments had changed by the time of confirmation. The court found that Manville was insolvent. Nonetheless, the court confirmed the plan which provided for the payment of pendency interest.¹¹⁰ The payment of pendency interest in the case of an insolvent debtor will presumably be a rare event, and it reflects the unusual presence in that case of a large class of "future" claims—that is, claims for injuries that had not yet manifested themselves, though they would inevitably occur based on past events.¹¹¹

¹⁰⁷ As an additional reason for the compromise, one of our interviewees cited the fact that until then there had been few cases allowing pendency interest.

¹⁰⁸ The equity committee was chaired by Jeffrey Chanin, a distinguished bankruptcy attorney who had also served as financial vice-president of Wickes Companies during its chapter 11 proceedings. Chanin certainly had the knowledge and ability to bargain effectively on behalf of the equity committee.

¹⁰⁹ Under the plan, the creditors to whom pendency interest was paid were commercial lenders and trade creditors, not the asbestos health claimants, most of whose claims were unliquidated.

¹¹⁰ The rates paid were considerably below the market. See *In re Johns-Manville Corp.*, 68 Bankr. 618, 637-38 (Bankr. S.D.N.Y. 1986), *aff'd*, 78 Bankr. 407 (S.D.N.Y. 1987), *aff'd*, 843 F.2d 636 (2d Cir. 1988).

¹¹¹ These are, of course, asbestos claims. As explained in footnote c to Table IV(A), our valuations did not include either the claims of, or the distributions to, classes of unliquidated claims. On this basis, we concluded that Manville was solvent. If this conclusion and the bankruptcy court's finding that Manville was insolvent at the time of confirmation are both correct, necessarily it is the asbestos claims that were underpaid. Significantly in this regard, there have been post-confirmation reports that

The Manville court offered two justifications for confirming a plan under which pendency interest was paid by an insolvent debtor. First, the only objectors to confirmation of the plan were common shareholders. The court concluded that they lacked standing to object to the provisions allowing pendency interest to unsecured creditors. In essence, the court reasoned that if pendency interest were denied to unsecured creditors, preferred shareholders rather than common shareholders would have had the right to the funds thus made available.¹¹² Yet, those preferred shareholders had accepted the plan by the requisite majorities.¹¹³ The second justification was quite unorthodox. The court stated that because the agreement to pay postpetition interest "represent[ed] a settlement of the claims of unsecured creditors reached among the parties,"¹¹⁴ it was not a "contested matter" and, therefore, the Bankruptcy Code provision disallowing pendency interest for disputed claims did not apply.¹¹⁵ The common shareholders voted against the plan, though, which was confirmed after a cram down hearing. Only if the common shareholders were ignored was it possible for the court to conclude that the payment of pendency interest was "uncontested." Thus, the decision ultimately rests on the court's determination that the common shareholders lacked standing to dispute the issue of pendency interest.¹¹⁶

Claims to pendency interest were not the only cause of "overpayments" to unsecured creditors. In *Storage Technology*, the overpayment was entirely unintended. At the time the debtor and creditor representatives agreed on the terms of the reorganization plan, they thought that the distribution to unsecured creditors would be slightly less than the full face amount of their claims. The

the Manville trust has insufficient funds to pay the claims of asbestos victims. See Labaton, *Asbestos Trust Fund of Manville Queried*, N.Y. Times, May 16, 1990, at D1, col. 4; Labaton, *Manville Trust Fund in Trouble*, N.Y. Times, Feb. 7, 1989, at D1, col. 6.

¹¹² See *In re Johns-Manville Corp.*, 68 Bankr. at 637-38. In this respect the court's rationale is unexceptional and represents the standard law that a party does not have standing to raise issues that could not benefit its distribution even if successful. See *supra* note 47 and accompanying text.

¹¹³ See *In re Johns-Manville Corp.*, 68 Bankr. at 621.

¹¹⁴ *Id.* at 637.

¹¹⁵ It is generally accepted that a plan approved by all classes can pay pendency interest. See Blum, *supra* note 95, at 434.

¹¹⁶ Perhaps the Manville decision is best understood in light of parties' failure to reach agreement on a plan for more than four years after filing. Presented with a choice between approving the payment of pendency interest and sending the parties back to renegotiate the plan, the court may simply have chosen confirmation as the lesser of two evils.

need to satisfy conditions of the plan prior to confirmation delayed confirmation until nine months after the bargain was struck. In the interim, the fortunes of the company had dramatically improved, as had the value of the reorganization securities to be delivered to both creditors and shareholders. Although we found no direct evidence that the increase in the value of the reorganization securities was anticipated at the time the reorganization plan was negotiated, it may nonetheless be significant that shareholders were virtually unrepresented in reorganization plan negotiations.¹¹⁷

Unsecured creditors are generally considered not to be entitled to pendency interest, and the figures in Table IV(A) therefore provide a reasonably good measure of how well the recoveries in these cases reflected the legal entitlements of the unsecured creditors under the absolute priority rule. We constructed Table IV(B) in order to compare the values of these recoveries with the amounts unsecured creditors would have received had they been paid both their allowed claims and pendency interest at full market rates.

In this table, the recoveries of the unsecured creditors have been discounted to their present values as of the filing of the bankruptcy petition.¹¹⁸ The figures in column 5 show that with the single exception of the "accident" in Storage Technology, the present values of creditors' recoveries as of the filing of the petition were less than the amounts of their claims on the same date. Accounting for the time value of money, therefore, creditors suffered a loss in nearly every case, even when the recoveries of shareholders were substantial. It becomes apparent that in the cases of solvent or nearly solvent companies of the type included in this study, the losses are shared, even in the "overpayment" cases.

¹¹⁷ Even though the company was solvent, the U.S. Trustee was unable to organize an equity committee. The Trustee declined to appoint two attorneys representing shareholders who had initiated class actions against the debtor based on pre-filing securities law violations, and he could find no other shareholders willing to serve. The CEO, installed during the proceedings and owing his job as much to creditors as to shareholders, adopted a neutral stance in plan negotiations.

¹¹⁸ That is, had creditors received both the full amount of their allowed claims and pendency interest at our discount rate, the numbers in column 5 would all be 100.

TABLE IV(B)

SOLVENT^a DEBTORS: CREDITORS' RECOVERIES ADJUSTED FOR THE LOSS OF TIME VALUE OF THEIR MONEY DURING PENDENCY OF THE CHAPTER 11 CASE^b

(1) Case Name	(2) Cents per Dollar to Unsecured Creditors (as of Confirmation) ^c	(3) Discount Rate Employed ^d	(4) Years from Petition to Confirmation	(5) Cents per Dollar to Unsecured Creditors (as of filing) ^e
Lionel	85.6	10.1%	3.6	60.5
AM International	86.1	12.5%	2.4	64.9
Charter	86.3	7.4%	2.7	71.1
Revere	92.7	9.4%	2.8	72.0
Penn-Dixie	96.8	15.3%	1.9	73.9
Salant	96.5	7.9%	2.2	81.7
Manville	125.3	8.5%	4.3	88.4
Continental	114.3	8.2%	2.8	91.7
Smith International	107.1	8.1%	1.7	93.8
Wilson Foods	104.7	10.1%	.9	96.0
Storage Tech	130.5	8.0%	2.6	106.9

^a Debtors were considered "solvent" if the total value distributed to unsecured creditors and shareholders under the plan exceeded the amount of the allowed unsecured claims.

^b In a chapter 11 case, the amounts of claims are fixed as of the filing of the case. Under the absolute priority rule stated in 11 U.S.C. § 1129(b)(2)(B), unsecured creditors are entitled to priority only for the nominal amounts of their claims, not for the time value of those claims. The degree of adherence to the absolute priority rule is shown in Table IV(A).

^c The amounts stated this column are from column (3) of Table IV(A). They are the values of the distributions to the holders of allowed unsecured claims (valued as of the date of the confirmation) divided by the amounts of those claims (as of the date of the filing of the petition).

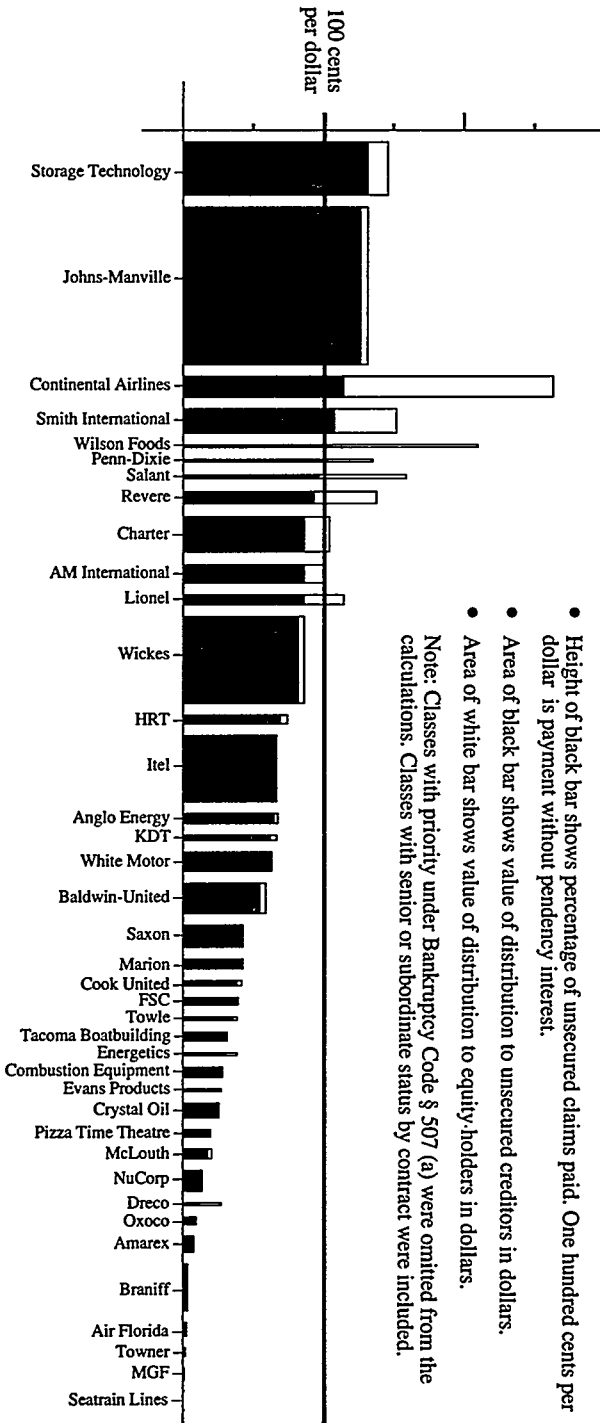
^d Discount rates are derived from the researchers' table of benchmark rates. The rate employed is the benchmark rate of interest on the date of confirmation for the period of the chapter 11 case. The rates stated on this table have been rounded.

^e This column shows the cents per dollar recovered by holders of unsecured claims reduced to present value as of the date of the filing of the petition, the date as of which the amounts of those claims were determined. Thus, the figures in column (5) take account of the time value of the unsecured creditors' money during the pendency of the chapter 11 case.

VII. POLICY IMPLICATIONS

The following bar graph shows the degree to which the results in the cases studied adhered to the absolute priority rule. The cases are arranged in descending order by percentage of unsecured claims

DISRIBUTIONS TO UNSECURED CREDITORS AND EQUITY



- Height of black bar shows percentage of unsecured claims paid. One hundred cents per dollar is payment without pendency interest.
- Area of white bar shows value of distribution to unsecured creditors in dollars.
- Area of white bar shows value of distribution to equity-holders in dollars.

Note: Classes with priority under Bankruptcy Code § 507 (a) were omitted from the calculations. Classes with senior or subordinate status by contract were included.

paid. The area of the black bar indicates the dollar value of the distribution to creditors in the case; the area of the white bar indicates the value of the distribution to equity. In the first five cases at the left, the heights of the black bars show that creditors were paid more than the full amounts of their claims, generally as pendency interest. In the remaining cases of solvent debtors,¹¹⁹ the deviations from the absolute priority rule in favor of equity classes are often substantial. But among the cases of insolvent debtors, the distributions to equity are only small percentages of the amounts paid to unsecured creditors.¹²⁰

Had the absolute priority rule been strictly enforced in the cases of insolvent debtors, recoveries by shareholders in twenty-one cases totaling \$154 million would have been eliminated. In the cases of solvent debtors shown on Table IV(A), unsecured creditors would have recovered at least 100 cents on the dollar of their claims.¹²¹ Further, if one believes that creditors should receive pendency interest so that they are "made whole" for the loss of the time value of money, there was only a single case in which this result was achieved.

Expressed as a percentage of the entire distribution in these cases, the deviations from the absolute priority rule are small and rarely exceed 10%. In absolute terms, however, they are substantial, virtually all measuring in the millions of dollars. In a few cases the size of the deviation exceeded \$50 million.¹²² Although we did not measure the deviations in favor of subdebt,¹²³ those deviations were probably greater than the deviations in favor of equity.

There has been much discussion about the high cost of professional fees in bankruptcy cases, and some lament that these fees are draining assets that could be used either to pay creditors or

¹¹⁹ Penn-Dixie through Lionel on the graph.

¹²⁰ Compare the area of the white bar to the area of the black bar for the same case. Note that the proportion of the distribution paid to equity in Dreco Energy was substantial, for reasons discussed *supra* note 51.

¹²¹ In the Lionel, AM International, and Charter cases, the shortfall to unsecured creditors was so large that it simply could not have been an artifact of our valuation protocols.

¹²² For example, according to our estimates, equity received \$63 million in Wickes, and in Charter, a solvent company at confirmation, creditors received \$58 million less than their allowed claims.

¹²³ We did not do so because there was often legal ambiguity about the rights of subordinated debt. See *supra* note 76. Consequently, for many cases it was impossible to construct an objective measure of the variation between subdebt's entitlements and its actual distribution.

to provide capital to the reorganized business.¹²⁴ Although we have not been able to systematically collect information about the size of these professional fees,¹²⁵ they were probably smaller than the deviations from the absolute priority rule observed in many of these cases.

Absolute priority is the rule of law for adjudicating cases in chapter 11. In enacting the current Bankruptcy Code, however, Congress expected that most chapter 11 cases would be resolved by agreement and that those agreements would include deviations from the absolute priority rule.¹²⁶ While it may seem peculiar to have a system which establishes one rule as the norm for adjudicated cases, knowing that different norms will be applied in the settled cases, which constitute the vast majority of outcomes, this is certainly not an unusual feature of the American legal landscape.¹²⁷

A. *Should the Absolute Priority Rule Be Enforced?*

There is intuitive appeal to the position that the bankruptcy system should be redesigned to ensure that creditors receive absolute priority. This position is sometimes defended by reference to a presumed "creditors' bargain." According to this view, the goal of bankruptcy policy should be to achieve results that creditors had reason to expect, and hence implicitly bargained for, when they originally extended credit. Proponents of this view normally assume that the results creditors can expect in the absence of a bankruptcy filing are the terms of the creditors' bargain.¹²⁸ They argue that

¹²⁴ See, e.g., S. STEIN, *A FEAST FOR LAWYERS* 126-30 (1989) (citing examples in which lawyers allegedly overbilled the debtors).

¹²⁵ Such information is not routinely included in disclosure statements. Fees which are charged against the estate are subject to court approval, and it therefore would be possible to collect information about these charges from court records. We were unable to undertake this effort, however, because our cases were filed all around the country.

¹²⁶ See *supra* text accompanying note 22.

¹²⁷ For example, legislators who conclude that the perpetrator of a particular crime should be sentenced to five years may nonetheless set the penalty at eight years based on empirical data showing that with the penalty at eight, the plea bargains will be at five. Once this system is in operation, however, it becomes unclear what the proper sentence ought to be for the perpetrator convicted without a plea bargain. If the crime is worth only five, it would seem that the temerity of putting the state to its proof must be worth three. Fortunately for criminal judges, this dilemma is not presented in such a stark form. There is virtually always a range of sentences that may be handed down, and a ready supply of background information about the defendant that can be used to distinguish the particular case and limit any deleterious precedential effects.

¹²⁸ This view is most closely associated with Dean Jackson. See T. JACKSON, *THE*

these results, which they call "prebankruptcy entitlements," should only be impaired in bankruptcy when it will permit greater overall distributions to creditors as a group; impairment should never be permitted to accomplish purely distributional goals, such as altering who gets what proportion of the debtor's assets.¹²⁹

If the "creditors' bargains" to which this argument refers are actual bargains premised on enforcement of the absolute priority rule,¹³⁰ the argument rests on a faulty premise. Real creditors live, lend, and strike their bargains in a world where they have every reason to believe that defaulting debtors will file bankruptcy petitions, and that in those bankruptcies, the absolute priority rule will not be strictly enforced. Creditors set their terms of credit, including interest rates, accordingly. To begin enforcing the absolute priority rule in the guise of "prebankruptcy entitlement" would, in the short term at least, give creditors a windfall.

There remains the question whether other considerations of policy favor strict enforcement of absolute priority. A number of scholars share Professor Baird's view that "a single set of rules should distribute losses that flow from a business failure Legal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them."¹³¹ The purpose underlying this objective is to avoid creating incentives for forum shopping, particularly incentives to choose a bankruptcy rather than a non-bankruptcy forum for the resolution of debt problems.¹³²

Absolute priority is the formal rule for distribution between creditor and shareholder of a large company in the absence of bankruptcy. In theory, at least, a creditor who is not paid can

LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 868-71 (1982) (maintaining that "creditors' bargain" explains normative underpinnings of the bankruptcy process from which practice and the Code itself seem to deviate).

¹²⁹ See Jackson & Scott, *supra* note 1, at 155-56.

¹³⁰ The hypothetical creditors' bargain might be understood simply as use of an "economic model," and hence not appropriately contradicted empirically. The statements nevertheless give the impression that they are about actual bargains reached by real creditors. See, e.g., Baird & Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 742 (1988) ("In these cases the appropriate course also is to allow the most senior creditor . . . to sell the assets of the firm The junior creditors and the shareholders cannot complain because they have bargained for a position inferior to that of the senior creditor with respect to all the assets being sold.").

¹³¹ Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822 (1987).

¹³² See *id.* at 826-28.

obtain a judgment, levy on property of the debtor, and force its sale. The rule for distribution of the proceeds is that nothing may be paid to the debtor until after creditors are paid in full.¹³³ Similarly, if a corporation is dissolved under state law, the assets are first applied to satisfy debts and only the remaining assets are distributed to shareholders.¹³⁴ Distributing dividends to the shareholders of an insolvent corporation is generally illegal.¹³⁵

Even though absolute priority is the doctrinal rule outside bankruptcy, it is not an accurate description of the actual pattern of distributions in such cases. Bargaining takes place outside bankruptcy as well, so it is far from clear that any difference exists in the patterns of distribution produced by the bankruptcy and non-bankruptcy systems. Under both systems, absolute priority governs adjudication. Yet under both, the parties are free to, and almost always do, enter into settlement agreements that deviate from the absolute priority rule.¹³⁶

Even if non-bankruptcy practices respected the absolute priority rule, it would not follow that the bankruptcy practice should be changed. Professor Baird points out that when state rules of distribution clash with bankruptcy rules on a particular point, the conflict itself does not indicate which should yield to the other.¹³⁷

¹³³ See, e.g., N.Y. CIV. PRAC. L. & R. § 5234(a) (McKinney 1978) (providing that the proceeds of personal property sold under execution should be distributed "to the judgment creditor and any excess shall be paid over to the judgment debtor").

¹³⁴ See, e.g., N.Y. BUS. CORP. LAW § 1005(3)(A) (McKinney 1986) (providing that "[a]fter paying or adequately providing for the payment of its liabilities: [t]he corporation . . . may sell its remaining assets . . . and distribute the same among the shareholders according to their respective rights").

¹³⁵ See, e.g., WIS. STAT. § 180.38(1) (1957 & Supp. 1989) (providing that "[t]he board of directors of a corporation may, from time to time, declare and the corporation may pay dividends . . . except when the corporation is insolvent . . .").

¹³⁶ For an interesting account of the corporate reorganization of a large, publicly held corporation outside bankruptcy, see B. MARSH, A CORPORATE TRAGEDY: THE AGONY OF INTERNATIONAL HARVESTER COMPANY 258-75 (1985). The reorganization consisted of a considerable debt for equity swap, but equity retained its shares.

Because normal corporate governance mechanisms are sometimes suspended in bankruptcy, see *supra* note 63, there is more reason to believe that corporate governance mechanisms operate to maintain management loyalty to shareholder interests outside, rather than inside, bankruptcy. We suggested earlier that management loyalty to shareholders is one reason cited for distributions to equity in bankruptcy. See *supra* text accompanying note 57. In the International Harvester negotiations, management consistently held out for the interests of equity in negotiations with creditor interests. See B. MARSH, *supra*, at 287-94.

¹³⁷ See Baird, *supra* note 131, at 823. Professor Baird states:

The only point Jackson and I make is that the priorities that exist under nonbankruptcy law should run parallel to priorities in bankruptcy. To the

If we approach the problem of reconciliation conservatively, seeking to determine which set of rules can be changed with the least disruption of existing practices, we must conclude that, at least in the case of large, publicly held companies, the state rule of absolute priority can be changed more easily than the bankruptcy rule of modified absolute priority. Such companies are rarely liquidated under state law procedures; when they fail they almost invariably wind up in bankruptcy. The bankruptcy rule is the only rule that actually distributes losses between creditors and shareholders in any sizable number of cases.

A second argument that might support strict adherence to the absolute priority rule rests on efficiency considerations. Scholars attempting to determine the most efficient legal rule often try to adopt a Rawlsian original position and to imagine what kinds of lending contracts creditors and firms would reach if they were to bargain on a clean slate.¹³⁸ From this perspective, a system of absolute priority may seem more efficient because substituting a "sum certain" for the uncertain amounts distributable under other systems reduces the strategic costs of competing for the debtors' assets and reduces variance in recoveries; this reduction is "a virtue to risk-averse creditors."¹³⁹

A priori arguments about efficiency based on hypothetical creditor bargains can usually be made for several possible resolutions of a particular issue. Thus, Professor Jackson, once associated with the view that enforcement of absolute priority would enhance efficiency, recently speculated, along with Professor Scott, that a scheme that leaves some value to junior interests might be more efficient in dealing with "common" risks and "eve of bankruptcy" risks.¹⁴⁰ Although Jackson's recent position can make one more comfortable with the results we have observed, it fails to account for why this pattern of results has developed.¹⁴¹ More to the point,

extent that these priorities generate bad distributional consequences, they should be changed in both settings.

To say that bankruptcy and nonbankruptcy priorities should be the same does not say anything about what those priorities should be.

Id.

¹³⁸ See, e.g., Jackson, *supra* note 128, at 860 ("A more profitable line of pursuit might be to view bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position.")

¹³⁹ *Id.* at 861-62. This rationale would support almost any rule that provides predictability of results.

¹⁴⁰ See Jackson & Scott, *supra* note 1, at 164-74, 190-94.

¹⁴¹ See Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and*

a priori reasoning, though producing useful insights, cannot establish factually what the most efficient rule governing distributions in bankruptcy would be.

The absolute priority rule may also be evaluated on the basis of fairness. From this perspective, one argument against strict enforcement of the rule is that it would eliminate sharing by "public" shareholders and "public" bondholders to the benefit of trade creditors and institutional lenders. If the former are presumed less powerful than the latter,¹⁴² the results observed may seem more equitable than strict application of the rule.

Publicly held securities and even creditors' claims are freely traded, however. By the time plan benefits are actually conferred at confirmation, the original "public" investors or creditors may have sold their securities or claims to professional investors. Market theorists may postulate that the public holders will nevertheless capture the benefit of distribution to junior claimants when they sell their securities and claims, because the market will anticipate the plan's distributional scheme and price these assets accordingly. In reality, in the forty-three cases we studied, public securities holders and even trade creditors often sold their claims and interests cheaply to more sophisticated professional investors who proceeded to realize a considerable profit.¹⁴³ It is possible, of course, that the price paid by these investors was greater than it would have

Economics, 75 VA. L. REV. 219, 234-38 (1989) (describing a similar reaction to the practice of reasoning from a hypothetical creditors' bargain).

¹⁴² Professors Blum and Kaplan contend:

Chapter X was drawn against a factual backdrop of senior debt held largely by public investors, in opposition to equity investment often drawn from other than widespread public sources. At present the prevailing pattern may be different; holders of senior debt may largely be institutional investors and public investment may be mainly in the form of subordinated debentures or preferred or common stock.

Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 661 (1974). The cases in our study corroborate this trend as the senior debt was typically held by banks, insurance companies, and, to a lesser degree, trade creditors. The subordinate debt and equity typically were publicly held.

¹⁴³ An extreme example was *Revere Copper and Brass*. In that case, professional investors purchased claims from trade creditors only months prior to confirmation for as little as 25 cents on the dollar. Under the plan, they could elect to receive a cash payment of 60 cents on the dollar. Even the cash payment only appealed to relatively unsophisticated investors or those interested in a quick profit. The more sophisticated institutional investors elected to receive promissory notes for 100 cents on the dollar with interest at 14% per year.

been if the absolute priority rule were strictly enforced, but this possibility is far from certain.

The most credible argument for strict enforcement of the absolute priority rule stems from concern that deviations from the rule are the product of "holdup" activity in which junior claimants abuse the adjudicative process and delay the proceedings in order to capture the "nuisance" value of positions that lack legal legitimacy.¹⁴⁴ Equity holders actually engaged in obstructionist tactics designed to extract a nuisance value settlement in only a few cases in our study. Still, there always was the implied threat that excluding equity holders might catalyze them to organize and engage in such activity. For example, at the time the plan was drafted in the McLouth Steel case, the company's only assets were its net operating loss carryovers, or NOLs. It was mathematically impossible to value the NOLs high enough to render the company solvent; in fact, creditors were compromising the amounts of their claims and then receiving an average of only eighteen cents on each dollar of the compromised claims. Despite the fact that equity holders had no committee, did not organize, and made no demands, the negotiators included them in the distribution, largely because of the concern that if confronted with a proposed plan that provided them with nothing, equity might organize and "kick sand in our faces."

Bankruptcy procedures foster such concerns. A plan of reorganization is essentially a settlement agreement among thousands of parties. Decisions about who will share and in what proportion must be made approximately three to five months before the plan comes before the court for confirmation. In the interim, the plan and the disclosure statement must be reduced to writing, and both must be approved by the negotiators; the disclosure statement must be approved by the court on twenty-five days notice; thousands of creditors and shareholders must be given ample time to vote; and the parties must prepare for the confirmation hearing. If the plan is to be modified, the holders adversely affected by the modification must be afforded twenty days notice and an opportuni-

¹⁴⁴ See Blum & Kaplan, *supra* note 142, at 664 ("A chief concern behind the adoption of the absolute priority doctrine was to prevent junior investors from gaining participation in a reorganized entity by trading on the nuisance value of otherwise worthless claims."); see also *In re Heck's, Inc.*, 112 Bankr. 775, 803-04 (Bankr. S.D.W. Va. 1990) (finding equity committee's obstructions improper).

ty to change their votes.¹⁴⁵ Thus, if a proposed plan excludes equity from distributions, the equity class will still have ample time to organize and mount an obstructionist campaign. This extended window of vulnerability means that equity neither has to engage in obstructionist tactics nor even make threats in order to generate leverage. Proponents of a plan must respond not just to equity's actions, but also to equity's potential actions.

If an official committee is appointed to represent the interests of equity holders, the expenses of that committee, including attorneys' fees, ordinarily are paid by the debtor.¹⁴⁶ In the case of an insolvent company, the effect is usually to impose the cost of equity's campaign on creditors. There is a risk that the bankruptcy court will refuse to award fees for a campaign it considers obstructionist,¹⁴⁷ but the committee's attorneys are often willing to assume this risk in order to obtain the case. Equity itself has no reason not to fight.

Not all deviations from the absolute priority rule stem from sound judgments about the potential strength of equity's leverage. We argued earlier¹⁴⁸ that there is a shared belief among the lawyers who regularly appear in these cases that consensual plans are the only practical method of resolving large chapter 11 cases. This belief is reinforced by the myth that cram down is expensive and time consuming. In cases in which creditors recover only a small proportion of their claims, we believe cram down can be achieved more easily than anticipated; our judgment is that an aggressive equity committee cannot impose extensive costs on creditors pursuing cram down in such cases unless it has support from the bankruptcy judge.¹⁴⁹ If this judgment is correct, it is

¹⁴⁵ See 11 U.S.C. § 2002(a)(6) (1988).

¹⁴⁶ See *id.* § 330. Court approval for the hiring of professionals is required. See *id.* § 1103(a). In the large cases we studied, retention of counsel was always approved. Retention of accountants and investment bankers was sometimes approved as well.

¹⁴⁷ In a recent case not in our sample, a bankruptcy judge reduced compensation to an equity committee after determining that it had taken actions for strictly dilatory reasons. See *In re Heck's, Inc.*, 112 Bankr. at 803-04. In an extreme case, an overzealous committee may be disbanded, as occurred in the Manville case. While we could get no direct confirmation from the attorneys we interviewed, it seems reasonable to suppose that such continuing court supervision had the effect of moderating the demands of equity committees in some instances. Direct confirmation of this hypothesis by the equity committee lawyers we interviewed would essentially have been an admission of less than zealous pursuit of the clients' interests for the purpose of protecting fees.

¹⁴⁸ See *supra* text following note 62.

¹⁴⁹ See *supra* text accompanying notes 34-47.

possible that in the future the deviations from the absolute priority rule will become less frequent in large cases, as creditor groups realize the feasibility of cram down. The shared belief in the impracticality of cram down may not be immutable, after all.

The shared belief may not change easily, however, and deviations from the absolute priority rule do result, to some extent, from sound judgments about equity's obstructionist potential. We therefore recommend a procedural innovation in bankruptcy practice. Deviations from the absolute priority rule resulting from equity's obstructionist potential could be reduced or eliminated if it were possible to obtain a determination early in a chapter 11 case that equity had no plausible entitlement to share in the distribution and therefore was not a party in interest.¹⁵⁰

Although it has always been assumed that the valuation that is the basis for cram down can only be made at the confirmation hearing, the Code does not mandate such a procedure. Bankruptcy courts could exercise their power to "issue any order . . . that is necessary or appropriate to carry out the provisions of this title"¹⁵¹ to determine, even before a plan has been proposed, whether specified claims or interests would be entitled to any property in a cram down.

Under our proposal, if such an order was entered against shareholders, one effect would be to release management from any

¹⁵⁰ Professor Blum developed the theoretical basis for such a determination in the context of chapter X:

The determination of which classes of creditors and shareholders shall have a voice in formulating the program of rehabilitation is treated under reorganization doctrine as a function of reorganization value. All classes whose claims, taken in the order of their priority and at their nominal amounts, fit within the reorganization value are considered as having a stake in the business. Accordingly these groups are allowed to participate through appropriate representation in drawing up the program and to vote upon it. The classes that are wholly eliminated by reorganization value are given more limited rights. To protect their interests they must be able to take part in hearings concerned with fixing that value, and have the right of appeal to correct irregularities or errors in the valuation process. Once reorganization value has been properly established the groups eliminated by it should have no further standing in the rehabilitation proceedings. Two exceptions might be in order. Eliminated classes perhaps should be allowed to demonstrate either that a change in conditions prior to completion of the proceedings makes it reasonable to increase reorganization value enough to accommodate them or that the business should be sold instead of reorganized because an advance in market prices enables them to share in the sale proceeds.

Blum, *supra* note 29, at 589.

¹⁵¹ 11 U.S.C. § 105(a) (1988).

further obligation to represent them in future plan negotiations.¹⁵² Similarly, if an order were entered against subordinated debentures, one effect would be to release the unsecured creditors' committee from representing them. In either situation, any committee previously appointed exclusively to represent the holders should be disbanded. The practical effect and purpose would be to eliminate the nuisance value of the affected claims or interests, and to permit those with a stake in the business to negotiate a solution to their problems in simpler circumstances, thereby reducing administration costs.¹⁵³

Of course, shareholders or creditors against whom such a preemptive cram down order was entered would not be prohibited from sharing under the plan. There are circumstances in which senior creditor interests might decide that it is in their own self interest to make a distribution to such junior claimants, and no rule would foreclose confirmation of such a plan.¹⁵⁴ For example, in a case in which there are only a few senior creditors, inclusion of a distribution to shareholders can help create a market in reorganization securities, by ensuring that such securities are widely held.¹⁵⁵ Under the tax law provisions, distribution of reorganization securities to junior creditors often preserves net operating loss carryovers, thereby positively contributing to overall firm value.¹⁵⁶ Managers whose knowledge or skills are essential to continuation of the business could also be permitted to share under a plan, perhaps even receiving all shares in the emerging company. They would, however, share expressly on that basis and not "on account of" their shareholdings.¹⁵⁷

¹⁵² Management's legal obligation to represent shareholders in plan negotiations and the extent to which they actually do so will be discussed in a subsequent article.

¹⁵³ After a preemptive cram down order is entered, it seems likely that consensus on a plan will be reached more quickly and easily, due to the smaller number of parties who need to be consulted.

¹⁵⁴ In this respect, the rule we propose differs from the old chapter X requirements, which mandated distribution in accordance with the absolute priority rule.

¹⁵⁵ See *supra* text accompanying notes 60-61.

¹⁵⁶ See *supra* note 62.

¹⁵⁷ See 11 U.S.C. § 1129(b)(2)(B)(i) (1988). This distinction has been recognized in the case law. See, e.g., *In re Potter Material Serv.*, 781 F.2d 99, 102 (7th Cir. 1986) (permitting sole shareholder to retain interest in debtor corporation because of his investment of new capital); *In re Landau Boat Co.*, 13 Bankr. 788, 792 (Bankr. W.D. Mo. 1981) (permitting investors to make substantial contributions to a reorganized corporation, although their old equity interest may be extinguished). It remains unclear whether these authorities still justify confirmation of such a plan in a cram down proceeding, because of the Supreme Court's decision in *Norwest Bank Worthington v.*

Based on our observations of the use of cram down,¹⁵⁸ we believe that even if the right to such preemptive cram down orders was clearly established, it would not result in a significant number of contested valuation hearings. If the shareholders' right to share in the distribution was in doubt, seeking such an order would not be cost effective for creditors. The hearing would be relatively complex and expensive, the court would be reluctant to foreclose claims or interests because of the possibility that circumstances would later change, and any order that was entered would be vulnerable on appeal or reconsideration. In close cases, and particularly when creditors are adverse to delay, as they usually are, it would continue to make sense to include everyone as part of a consensual plan. Like cram downs, preemptive cram downs seldom would be tried against claims or interests not clearly underwater.¹⁵⁹

Preemptive cram down orders would eliminate sharing by equity and subordinated debt holders in some cases. We do not think this elimination would conflict with the congressional intent of the 1978 modification of the absolute priority rule. Congress expected negotiated plans of reorganization to deviate from the absolute priority rule, but the legislative history is consistent with the view that Congress retained the absolute priority rule as the ideal, accepting bargaining by the parties only to eliminate the necessity for the court to value the company in every case.¹⁶⁰

Our proposal is less radical than others that have been made for insuring compliance with the absolute priority rule. Professor Roe has recommended amending chapter 11 to require that only cash and reorganization shares be distributed under a plan.¹⁶¹ To facilitate such a scheme, and to avoid the need for the bankruptcy

Ahlers, 485 U.S. 197, 202-11 (1988) (rejecting a reorganization plan as contrary to the absolute priority rule because the recipients of shares had contributed only "sweat equity"). See Klee, *supra* note 13, at 239-44 (noting that after *Ahlers* was reported, "courts began equivocating on survival of the new value exception" that permitted new contributions by owners). Little doubt exists, though, that such a plan can be confirmed if agreed to by all classes.

¹⁵⁸ In the cases studied, cram down was employed principally to establish obvious facts in the absence of opposition. Of the 21 cram downs in these cases, only three resulted in a contested hearing. See *supra* Table II following note 31.

¹⁵⁹ The bankruptcy courts could, and probably should, use their discretion over fee awards to ensure that preemptive cram downs are not sought in inappropriate situations.

¹⁶⁰ See *supra* text accompanying note 22.

¹⁶¹ See Roe, *supra* note 1, at 597-62.

court to place a value on the shares to be distributed under the plan, he proposed that 10% of the shares in the reorganized company be marketed before confirmation. The purpose would be to establish objectively a value for the reorganization shares, a value that could then be used to divide the remaining shares between creditors and shareholders strictly in accordance with the absolute priority rule.¹⁶²

Professor Bebchuk has offered a proposal with a similar thrust, though differing in important details.¹⁶³ In effect, he would give all reorganization securities to the senior creditor class, while extending to junior classes the right to redeem the shares from the senior class by paying the senior class's claims in full.¹⁶⁴ Professor Baird has suggested that all companies in chapter 11 be sold as a unit for cash to the highest bidder,¹⁶⁵ with the proceeds presumably distributed strictly in accordance with the absolute priority rule.

One objective of each of these proposals is to ensure strict application of the absolute priority rule. Each proposal reflects a strong belief in the ability of the market to value correctly the worth of a corporation undergoing reorganization. Professor Baird's faith is placed in the market for buying whole companies, even very large ones. Professors Roe and Bebchuk place their faith in the markets for reorganization securities. We do not share their faith. Any valuation of a corporation undergoing reorganization, whether by the market or by judicial process as under the old chapter X, is only approximate.¹⁶⁶ That being the case, fairness considerations do not compel strict compliance with the absolute priority rule, particularly since, as our data shows, the extent of deviations from the absolute priority rule is modest in most large cases. Furthermore, as we have argued above, there are reasons to believe that distributions strictly in accordance with the absolute priority rule

¹⁶² See *id.* at 559.

¹⁶³ See Bebchuk, *supra* note 1, at 781-97.

¹⁶⁴ If there are several junior classes, the most senior of the junior class would have the redemption right initially, and more junior classes, such as equity, could redeem from a junior class that is more senior and had earlier exercised a redemption right. In effect, equity could retain the reorganization shares by paying all creditor claims in full. See *id.* at 788-92.

¹⁶⁵ See Baird, *supra* note 1, at 136.

¹⁶⁶ In our study there were numerous occasions where reorganization securities did not actively trade until after their issuance, and even then it was only possible to get bid-ask quotes. With such little trading there is more reason to question the accuracy of the market's valuation.

are not always in the creditors' best interests. For example, at times a small distribution to equity can help to ensure a market in reorganization securities.¹⁶⁷

Our proposal would make it easier for senior parties to compel adherence to the absolute priority rule in cases in which creditors will clearly receive only a small part of their claims, and at the same time it would permit those parties to agree to a different distribution scheme if there is good reason to do so. Its goal is elimination of distributions to junior interests that result solely from actual or feared abuses of legal process.

B. *Are Junior Interests Being Short-Changed?*

In some cases in which equity recovered more than they would have been entitled to in an adjudication under the absolute priority rule, there remains an argument that they are being short-changed. The argument is based on the Realist proposition that it is outcomes, not announced rules, that constitute the law.¹⁶⁸ Absolute priority should not be considered the norm, because the same Bankruptcy Code that establishes it as the rule for adjudication also establishes procedures that lead to equitable sharing between creditors and shareholders in the large majority of cases.¹⁶⁹ Under this argument, equity is short-changed in some cases because they are denied use of the procedures that would enable them to force an equitable sharing.

Our data suggests that consolidating representation of equity through appointment of an equity committee is an important element of that procedure. In every case in which a committee was appointed, equity received a share in the distribution regardless of how little was distributed to unsecured creditors. If committees had been appointed in the remaining cases, we think that equity holders would have shared in those distributions as well.¹⁷⁰

¹⁶⁷ See *supra* text accompanying notes 60-61.

¹⁶⁸ See K. LLEWELLYN, *THE BRAMBLE BUSH* 12 (1951).

¹⁶⁹ See *supra* Tables III, IV(A) & IV(B) following notes 33, 90 & 118.

¹⁷⁰ When Congress adopted the 1938 Bankruptcy Act, it expressed concern about collusion between management and bank interests that short-changed less well organized interests such as publicly held debt. Many of the protections for less well organized interests that were instituted in 1938 have since been repealed, such as the mandatory appointment of trustees, court review of bargains to assure that they were in compliance with the absolute priority rule, and enhanced judicial control over the process of appointing committees. In a separate article based on the data from this study which will focus on the role and loyalties of management in the large chapter 11

Considering the importance of equity committees to the interests they represent, the process by which they may come into being in a particular case is worthy of examination. The Bankruptcy Code provides for appointment of an equity committee only if the court determines that a committee is "necessary to assure adequate representation,"¹⁷¹ or, in a U.S. Trustee district, the U.S. Trustee deems appointment appropriate.¹⁷² The initiative for appointment of equity committees in our study came primarily from three sources: the SEC,¹⁷³ existing shareholders, and investors who bought shares after the filing of the bankruptcy case. In most of the cases in which there was no equity committee, there was no request for one. There were, however, three notable exceptions. In Pizza Time Theatre, motions filed by equity holders and supported by the Securities and Exchange Commission were denied by the court, apparently because equity interests were so far underwater that the court thought that funds should not be expended in their representation. In Storage Technology, the U.S. Trustee refused to appoint a committee because two of the three equity holders willing to serve were class action plaintiffs in securities litigation.¹⁷⁴ In Manville, the court disbanded the official equity committee after it opposed confirmation and attempted to convene a shareholders' meeting to replace management.

In each of these cases, the denial of a committee inevitably altered the ultimate bargain contained in the reorganization plan. The courts and U.S. Trustees reached their decisions without explicit consideration of the evidence bearing on what the distribution to equity should be. On the other hand, there is no way to be neutral in such circumstances. In Pizza Time Theatre, a decision to

cases, we will argue that money center banks and other institutional lenders were frequently able to win the allegiance of management and thereby considerably reduce the power of junior creditors and shareholders. This observation is an additional reason to be concerned about the lack of representation of equity in these cases.

¹⁷¹ 11 U.S.C. § 1102(a)(2) (1988).

¹⁷² See *id.* § 1102(a)(1). This basis for appointment was applied in only some districts during most of the period covered by our study. Currently, it applies in nearly all districts.

¹⁷³ A member of the SEC's General Counsel staff told us that the Commission had either moved for or supported a motion for the appointment of an equity committee in 16 of the cases in our study.

¹⁷⁴ In many of the cases in our study, when the bankruptcy petition was filed, there were actions pending against the debtor on behalf of investors who alleged that they had been defrauded in their pre-bankruptcy purchase of the debtors' securities. Membership on an equity committee can be an easy way for such persons to obtain discovery and was therefore commonly resisted by management.

appoint an equity committee would almost inevitably have led to a larger distribution to the equity class, which many would consider inappropriate given the low payout to creditors.

Such judicial control over the outcome of informal bargaining is not limited to the decision to appoint or refuse to appoint an equity committee. The court also may determine the level of logistical support that will be available to the committee. Equity committees are almost always more moderately staffed than creditors' committees. While all equity committees in our study had an attorney, equity committees were much less likely than other committees to be advised by accountants or investment bankers.

Many decisions to appoint equity committees and allocate resources to them were probably based on judgments about whether equity should share in the bargain. Although the absolute priority rule is not enforced at confirmation of a consensual plan, it is loosely and inconsistently enforced in the decisions on whether to appoint equity committees and on what level of resources to provide them. A better system would allow judges to determine directly whether equity and other junior interests should participate in the distribution. Our preemptive cram down proposal would permit that determination. If that reform were adopted, U.S. Trustees could then appoint equity committees early in the case without thereby determining that equity will participate in the distribution.¹⁷⁵ A subsequent preemptive cram down could still prevent such a distribution.

The SEC recently initiated a procedure to reevaluate its role in bankruptcy reorganization cases.¹⁷⁶ Since 1983, the SEC has limited its function primarily to moving for appointment of committees to represent public security holders and to reviewing the adequacy of disclosure statements.¹⁷⁷ It does not participate in reorganization plan negotiations, and it does not challenge proposed plans on their merits at confirmation.¹⁷⁸ The Commis-

¹⁷⁵ Under the reform we have suggested, if the judge could determine from the very beginning of the case that equity should not participate, it would be appropriate to refuse appointment of an equity committee.

¹⁷⁶ See Request for Public Comments on the Role of the Securities and Exchange Commission in Reorganization Cases Under Chapter 11 of the Bankruptcy Code, Corporate Reorganization Release No. 384, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,502 (Oct. 18, 1989). As of this writing, twelve months after the request for comments, there has been no official action by the SEC.

¹⁷⁷ The SEC has statutory authority to raise and contest any issue in a chapter 11 proceeding. See 11 U.S.C. § 1109(a) (1988).

¹⁷⁸ The policy change was announced by the SEC in 1983. See General Counsel's

sion is now questioning whether it should continue to play even this limited role, given that public security holders can act on their own to secure appointment of a committee.

We believe that the SEC has played a valuable role in the cases in our study and that it should remain active in the reorganization of large, publicly held companies. The Commission's most important function has probably been as a catalyst in the formation of equity committees. Even in the reorganization of solvent companies, the interests of public shareholders can suffer simply because they are not present at the bargaining table.¹⁷⁹

Lack of representation of shareholders might be justified theoretically if shareholder interests were asserted by management or if shareholders, collectively, did not consider representation worth the cost. That does not, however, appear to be an accurate description of what happened in a number of our cases. There are several cases in which no shareholder stepped forward to ask for the appointment of a committee, even though management was not asserting their interests. There are several possible reasons for this phenomenon which belie any assumption that the shareholders as a group decided that representation was not worth the cost. One such reason is the classic "free rider" problem: a shareholder receives no greater distribution than other shareholders because she or he took the initiative to get the committee appointed. Members of an equity committee may not even be reimbursed for their out of pocket expenses, let alone compensated for their time. Moreover, because of their status, committee members may be barred from trading in the company's stock by the insider trading rules.¹⁸⁰

Statement Concerning Commission's Participation in Bankruptcy Reorganization Cases, Corporate Reorganization Release No. 331, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,484 (Feb. 2, 1984). The current practices, as described in the text, reflect an even more limited involvement by the SEC than was necessarily contemplated when the policy statement was issued.

¹⁷⁹ The best example from our study is Storage Technology. See *supra* text accompanying note 117.

¹⁸⁰ One possible solution to this problem could be to collectivize the shareholder position into the hands of one person or a small group, so that the person[s] who incur the costs of representing the equity position reap all the benefits of that representation. As discussed earlier in this Article, in several cases small groups of investors have acquired a controlling block of subordinated debentures or other type of junior debt and then have taken the lead in representing that class in reorganization plan negotiations. Only rarely, though, have investors shown such an interest with respect to an equity class. See *supra* notes 81-87 and accompanying text.

Where these factors impede the process of committee formation, the SEC can be the necessary catalyst. The SEC is better suited to perform this role than the United States Trustee. The bankruptcy reorganizations of large, publicly held companies are filed throughout the United States, and the U.S. Trustee's office in any city other than New York is unlikely to be involved in enough of these cases, as compared with the much more numerous smaller bankruptcies, to develop the expertise necessary to analyze them and act effectively in them.

CONCLUSION

This Article is the first of several that report the findings of an empirical study of the bankruptcy reorganization of large, publicly held companies. The data reported here bear on what many consider to be the central issue of reorganization theory: how the value of the reorganizing enterprise should be divided among the various claims and interests. Our basic conclusions, which follow, are based on our study of the forty-three largest publicly held corporations to reorganize between 1979 and 1988.

First, bargaining and settlement rather than adjudication determined the outcomes of the cases in our study. Despite the widespread publicity given to the highly aberrant Evans Products case, a contested cram down against shareholders was a rare event. When Congress in 1978 authorized the confirmation of a consensual plan without a formal adjudicatory finding that the plan was fair and equitable, it marked the practical end of adjudication as the final step in large bankruptcy reorganizations. The bargain that was struck among representatives of the various classes determined the outcome of our cases; its ratification by the individual holders of claims and interests appeared to be a mere formality.

Second, shareholders of insolvent companies nearly always shared in the distribution under the plan. Among the cases studied, this phenomenon ordinarily occurred even if the representatives of equity refused to consent to the plan.¹⁸¹ With one exception, equity was "zeroed out" only in cases in which creditors were receiving less than fourteen cents on the dollar. Though equity regularly shared in the distribution in these cases, equity's share almost invariably was small when measured as a percentage of the total distribution. When compared with the outcomes of chapter 11

¹⁸¹ Examples of this phenomenon in our study are HRT and Manville.

cases involving smaller companies,¹⁸² absolute priority can be seen as a generally accurate description of the outcomes in these large cases. Within the category of large cases, the relative size of equity's recovery appeared to be not so much a product of the financial conditions of the company as it was a product of the quality and aggressiveness of equity's representation.

Third, in the cases of insolvent debtors, the observed deviations from absolute priority were not to any significant degree the product of difficulties in valuation. In nearly every case, the negotiators knew the company was insolvent and that equity would be entitled to nothing in an adjudication. Equity was allowed to share in the distribution for a wide variety of reasons. Central among them was a generalized desire to have a consensual plan—one supported by the debtor, the official committees, and major creditors. Part of the reason for seeking such a plan was a concern that equity might make trouble if there was an attempt to exclude it. Yielding to such a fear was easier for creditors because the cost of a distribution to equity was spread among so many creditors that the portion borne by each one was too small to justify resistance. To a large degree, however, the preference for a consensual plan rather than an adjudication was a matter of legal culture. Although these cases were spread throughout the United States, most of the lawyers who played key roles in them were members of the same legal community. They could expect to be involved in future cases with their current adversaries and were to various degrees dependent on those adversaries for professional respect and advancement.¹⁸³ They were not entirely free to ignore the conventional wisdom that consensual plans were the responsible, appropriate means for accomplishing reorganization and that despite the absolute priority rule, everyone at the bargaining table was entitled to a share.¹⁸⁴

Fourth, in the cases in which the debtor was marginally solvent, there were substantial deviations from the absolute priority rule, leading to a kind of "equitable sharing" between creditors and

¹⁸² For a discussion of studies of these smaller cases, see *supra* notes 48-50 and accompanying text.

¹⁸³ See *supra* notes 65-66 and accompanying text.

¹⁸⁴ Ironically, the lawyers receiving the most benefit from the norm favoring consensual plans, the "spoilers" who made a practice of representing aggressive equity and subdebt holders, were usually not members of the same legal community. The relations were often hostile between these spoilers and the lawyers who represented debtors, creditors' committees, and major creditor interests.

equity holders. In part, this sharing was a product of perceived difficulties with valuation. Although it is difficult to generalize because the number of such cases was so small, aggressive representation seemed to yield big rewards for equity holders.

Fifth, in the cases of clearly solvent debtors, claims for pendency interest highlight an important ambiguity in the absolute priority rule: does the rule require that creditors have absolute priority over shareholders only for the face amounts of their claims or should the time value of the creditors' money also be protected? In four of our cases, the bargain included the payment of at least some pendency interest. If we assume that creditors are entitled to pendency interest at full market rates, then in only one of our solvency cases did creditors receive full payment.¹⁸⁵ In that sense, it truly can be said that the overall pattern in the cases of both solvent and insolvent debtors was an "equitable sharing" of the loss between creditors and shareholders.

Perhaps because it resolves public issues through inaccessible, largely private bargaining, the system for reorganizing large, publicly held companies has been the subject of much criticism. With regard to the bargain over equity's share in the distribution, while the dollar amounts of the deviations in favor of equity are large, for the most part they are only a small percentage of the overall distribution in these cases. Many perceive these deviations as the "grease" that permits complex and otherwise unwieldy cases to reach relatively expeditious conclusion. While we believe that the elimination of relatively small deviations from the absolute priority rule does not warrant the radical changes in chapter 11 that have been proposed,¹⁸⁶ participation in these cases by junior claims and interests clearly not entitled to a share under the absolute priority rule may generate unnecessary complexity and expense and encourage obstructionist tactics. The "preemptive cram down" that we propose¹⁸⁷ should permit the bankruptcy courts to limit these deleterious effects.

¹⁸⁵ In that case, this level of payment was more by accident than design. See *supra* text accompanying note 117 (discussing the Storage Technology case).

¹⁸⁶ See Baird, *supra* note 1, at 129-35; Bebhuk, *supra* note 1, at 781-88; Roe, *supra* note 1, at 559-93.

¹⁸⁷ See *supra* notes 150-59 and accompanying text. The pattern of settlement that this proposal seeks to alter is based on a custom which we consider unstable: it may be, therefore, that this change in results will come about without the need for any change in bankruptcy court practice. See *supra* text accompanying notes 148-49.