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CREDITORS' BALL: THE "NEW" NEW CORPORATE GOVERNANCE IN CHAPTER 11

DAVID A. SKEEL, JR.[†]

For well over a year, the papers have been filled with hand wringing about the sorry state of American corporate governance. We read that Wall Street's watchers—especially the securities analysts and auditors—were so riven with conflicts of interest during the stock market boom that the only things they were watching were their own bank accounts. As I write, the former chairman of the Securities and Exchange Commission ("SEC") is barnstorming the country, telling everyone that he tried to warn us back in the 1990s. The SEC needed more money, he says, among many other complaints, and more freedom from political interference to do its job.¹

For the companies that epitomized the governance crisis, bankruptcy is now where the action is. Nearly all of them—Enron, WorldCom, Adelphia, Global Crossing—currently are doing their business in Chapter 11. An observer who followed the bankruptcy literature (and the occasional *New York Times* or *Wall Street Journal* article) in the 1990s, and who had lost touch since then, might well have expected the filings to prompt a second round of hand wringing, this time about America's miserable bankruptcy framework. A decade ago, many observers believed that Chapter 11 was irretrievably flawed.² Yet here we are, only a few years later, and surprisingly few people seem to be complaining about corporate bankruptcy. One hears occasional

[†] Professor of Law, University of Pennsylvania. I am grateful to Barry Adler, William Bratton, Jesse Fried, Rishi Gupta, Melissa Jacoby, Lynn LoPucki, Bruce Markell, John Pottow, Bob Rasmussen, Bill Schorling, Alan Schwartz, Michael Whincop, and Todd Zywicki; to the Bankruptcy and Creditors' Rights practice group of Klett, Rooney, Lieber & Schorling; to participants at the University of Pennsylvania Law Review's Corporate Control Transactions Symposium on February 8–9, 2003 for helpful comments; and to the University of Pennsylvania Law School for generous summer funding.

¹ This Article was first written in late 2002. The ex-chair of the SEC is Arthur Levitt, and his complaints are chronicled in the book, ARTHUR LEVITT, JR., TAKE ON THE STREET 131-33 (2002), which was the occasion for the tour.

² For a discussion of the concerns with, and a critique of, the principal proposals to replace Chapter 11 with an alternative regime, see David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 466-94.

worries, to be sure. There was a brief flurry of articles suggesting that Chapter 11 may have been too “biased toward saving failing firms;”³ WorldCom competitors such as Verizon and AT&T have complained that bankruptcy has given WorldCom unfair advantages;⁴ and there have been running accounts of the size of the professionals’ fees in the Enron case.⁵ But these days bankruptcy is more often described as a solution than as a problem.

Perhaps this simply shows that it’s all relative: American corporate governance looks so bad at the moment that even a deeply flawed bankruptcy framework comes out smelling like a rose by comparison. Another possible explanation is that Chapter 11 was always a better system than its most fervent critics contended.

Both of these explanations are at least partially true. I plan, however, to focus on a third explanation: the fact that Chapter 11 decision making itself has changed quite dramatically in the past decade. The endless negotiations and mind-numbingly bureaucratic process that seemed to characterize bankruptcy in the 1980s have been replaced by transactions that look more like the market for corporate control. Whereas the debtor and its managers seemed to dominate bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast. Chapter 11 no longer functions like an anti-takeover device for managers; it has become, instead, the most important new frontier in the market for corporate control, complete with asset sales and faster cases.

Unlike the “new” bankruptcy governance ushered in by Congress in 1978,⁶ the “new” new⁷ Chapter 11 governance is contractual in

³ Daniel Altman, *Chapter 11? Or Time to Close the Books?*, N.Y. TIMES, Dec. 15, 2002, § 3, at 1 (quoting Michelle J. White, an economics professor at the University of California at San Diego) (internal quotes omitted); see also Sarah McBride, *Australia’s Tough-Minded Bankruptcies May Serve as Role Model*, WALL ST. J., Dec. 16, 2002, at A2 (asking whether “the U.S. system—one that follows a ‘rescue’ approach . . . —wastes economic resources, diverts funds to hefty legal and consulting fees and slows down overall economic growth”).

⁴ See, e.g., *infra* note 73 and accompanying text (describing the competitors’ complaints about WorldCom)

⁵ See, e.g., David Barboza, *Lawyer Proves a Thorn for Enron’s Partners*, N.Y. TIMES, Sept. 21, 2002, at C1 (describing how the Atlanta-based firm of court-appointed examiner, Neal Batson, is billing Enron \$3 million a month to investigate its activities and partners); Mitchell Pacelle, *Enron Bankruptcy is Fee Bonanza: Lawyers’ Laundry and Bartab among \$280 million in Charges*, WALL ST. J., Dec. 11, 2002, at C1 (describing the legal fees and the approval process for those fees).

⁶ Chapter 11 replaced the much harsher provisions of the previous Bankruptcy Act with provisions permitting the debtor’s managers to continue running the business, giving them the exclusive right to propose a reorganization plan for the first

nature. Creditors have converted two existing contractual tools into important governance levers.⁸ The first is debtor-in-possession (DIP) financing. Before they even file for bankruptcy, corporate debtors must arrange an infusion of cash to finance their operations in Chapter 11. To an increasing extent, lenders are using these loan contracts to influence corporate governance in bankruptcy. The fate of an asset or division of the company, even the terms of a transfer of control, has been spelled out as terms in a debtor's DIP financing agreement. The second is that key executives are increasingly given performance-based compensation packages in Chapter 11. The most common strategy is to promise the executives a large bonus if they complete the reorganization quickly; likewise, executives face ever-smaller bonuses if the case takes longer.

My aim in this Article is to make sense of these developments, both by putting them into historical context and by identifying the concerns they raise. In Part I, I describe the complaints about Chapter 11 in the 1980s and the increasing use of DIP financing agreements and performance-based pay to reshape Chapter 11 governance. I also explain how creditors can influence the composition and focus of the debtor's board of directors during the bankruptcy case. In Part II, I briefly summarize the virtues of the new Chapter 11 governance. In Parts III and IV, I consider some of the concerns raised by each of the governance levers. With respect to DIP financing (the subject of Part III), I point out that the DIP lender's priority status can produce a variety of troubling effects. An existing lender may use the new financing arrangement to improve its pre-bankruptcy position. Some lenders may also have too great a bias toward liquidation, which could hurt creditors as a whole and in coming years could undermine an

one hundred twenty days of the case, and relying on negotiations between the debtor and its creditors to effect the reorganization. For a detailed discussion of the history and implications of Chapter 11's new governance regime, see DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 160-83, 212-37 (2001).

⁷ With apologies to Michael Lewis. MICHAEL LEWIS, *THE NEW NEW THING* (2000).

⁸ Another important development—albeit one that was well underway in the 1980s—is the role of the market for claims in Chapter 11. I have discussed this development, and its use as a device for acquiring control of the corporate debtor, in other work. See Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 101-04 (1995) (noting the “exponential increase in claims trading” and discussing a claimant's potential acquisition of enough claims to exercise veto power over proposed reorganization plans); David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 513-18 (1992) (describing the same dramatic increase in claims trading and the same potential for the acquisition of veto power).

aspect of Chapter 11 that I refer to as its "antitrust benefit." Although the debtor's managers agree to the terms of the financing, they cannot be expected to focus on the best interests of the firm when it has encountered financial distress. With executive compensation (Part IV), I argue that pre-bankruptcy bonuses raise serious fairness and efficiency concerns, but that the concerns are much weaker in the post-petition environment.

The prescriptive tone of this analysis should not obscure the fact that the two governance levers have dramatically improved the quality of Chapter 11 governance. Part V makes this explicit by re-emphasizing the virtues of the new regime.

I. CH-CH-CHANGES

The late 1980s and early 1990s were both the best and the worst of times for large-scale corporate reorganization in America. The enactment of the 1978 Bankruptcy Code⁹ had taken off the fetters that stymied corporate bankruptcy for forty years. Chapter X of the Chandler Act¹⁰—the chapter designed for large corporations under the old Bankruptcy Act—replaced the managers of a debtor that filed for bankruptcy with a court-appointed trustee. Chapter 11 of the new 1978 Code, by contrast, authorized the managers to continue operating the business and gave them the exclusive right to propose a reorganization plan.¹¹ The number of large Chapter 11 cases soared, but there were also a growing number of complaints about the very provisions that had restored bankruptcy's luster. Chapter 11 seemed to give *too* much control to the debtor's managers, enabling them to stiff-arm creditors and drag out the bankruptcy cases for inordinate periods of time. Managers were playing with creditors' money, and large cases often lasted several years or more.¹²

The worst offender was Eastern Airlines (Eastern). Although it was clear to just about everyone that Eastern should be sold, Eastern's CEO Frank Lorenzo postponed the inevitable for several years as

⁹ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. 101 et seq. (2000)).

¹⁰ Chandler Act of 1938, ch. 575, 52 Stat. 840, 883 (repealed by Pub. L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2549, 2682 (1978)).

¹¹ As noted earlier, I have discussed these developments in detail elsewhere. See *supra* note 6 (describing Chapter 11 provisions that replaced the harsher Bankruptcy Act).

¹² See, e.g., Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 739-45 (surveying data on case duration).

Eastern's value deteriorated. In the end, Eastern's assets were liquidated at a fraction of what they had been worth at the outset of the bankruptcy case.¹³

With Eastern as their poster child, critics began to call for major changes to Chapter 11. In the bankruptcy literature, a vibrant debate developed as to whether Chapter 11 should be replaced by a faster, more market-oriented alternative.¹⁴

And then a funny thing happened. The most obvious problems with Chapter 11—the endless cases and absence of market discipline—started to disappear. Within a few years, there were more auctions in bankruptcy, and claims trading sometimes simulated a market for corporate control.¹⁵ In the past several years, the changes have been even more dramatic. In most large cases, the same creditors who seemed so helpless only a few years ago are now calling most of the shots.¹⁶ Chapter 11 is still remarkably debtor friendly by international standards, but creditors now exert much more influence over a case than at any time in recent history. The result is faster cases that rely more on asset sales and the market for corporate control than on negotiations to move the restructuring process along.

¹³ See, e.g., Claudia MacLachlan, *Blame Flies in Demise of Airline*, NAT'L L.J., May 27, 1991, at 1, 35-36 (detailing how unsecured creditors' shares fell to only 2.8 cents on the dollar and assigning blame for Eastern's demise to Lorenzo).

¹⁴ Among the most prominent proposals were calls for a stock cancellation scheme and for both traditional and options-based auctions of the debtor's business. See, e.g., Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-33 (1993) (proposing a "chameleon equity" scheme that would cancel existing stock and convert lowest priority debt into new stock); Philippe Aghion et. al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 532-36 (1992) (developing the options-based auction idea); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 136-38 (1986) (advocating a standard auction of the bankrupt company's assets); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785 (1988) (proposing an options scheme that would permit each shareholder or creditor to acquire an equity interest if they paid a pro rata share of all higher priority claims); but see Skeel, *supra* note 2, at 472-93 (describing and critiquing each of the proposals).

¹⁵ For a discussion of the role of the market for Chapter 11 claims, see Rasmussen & Skeel, *supra* note 8, at 101-05.

¹⁶ The recent airline bankruptcies—US Airways and United—are a particularly good example. In United, the lenders' cost reduction requirements have induced the company to make major layoffs. See Susan Carey, *UAL Will Lay Off 1,500 Workers as Part of Cost-Cutting Strategy*, WALL ST. J., Jan. 6, 2003, at A3 (reporting United's plan to meet financing goals by laying off fourteen percent of its employees). US Airways's principal lender threatened to force liquidation unless unions agreed to major pay-cuts. Micheline Maynard, *US Air's Chief Lender Threatens the Ultimate*, N.Y. TIMES, Dec. 7, 2002, at C1.

How did everything change so fast? In part, the transformation reflects a change in the profile of American business. Unlike the businesses that traditionally landed in bankruptcy—railroads, in the nineteenth century, or industrial firms thereafter—many contemporary businesses depend on knowledge and ideas rather than on hard assets. Because these companies' most important assets can walk out the door at any moment, they cannot afford to negotiate for months or years toward an eventual restructuring. They must resolve their difficulties immediately; often, the only way to do this is to sell key assets at or shortly after the time of bankruptcy. In addition, markets for assets, and even for entire companies, are much more liquid than ever before.¹⁷

More importantly, several remarkable contractual developments have been intertwined with this shift in the nature of American business. First, lenders increasingly have used their post-petition financing agreements to shape the governance of the Chapter 11 case. The second contractual strategy makes a direct appeal to managers' wallets. By crafting "pay to stay" agreements that depend heavily on bonuses based on the speed of the reorganization or the price obtained in asset sales, creditors have given managers dramatically different incentives than they had in the 1980s.

These contractual changes have shifted the ethos of bankruptcy in ways that go beyond the contracts themselves. Although bankruptcy law does not formally authorize creditors to displace the company's directors, creditors have increasingly exercised *de facto* control. Directors are now more likely to respond, for instance, to creditors' not-so-subtle threat that "sooner or later we'll own the company and we're not going to re-elect you so you should get out now."¹⁸

The following subsections briefly describe and explain each of these new developments.

¹⁷ See, e.g., David A. Skeel, Jr., *The Crash of Enron*, PHILA. INQ., Dec. 9, 2001, at D5 (characterizing these developments as "New Economy Bankruptcy"). The shift from traditional corporate reorganization to sales of assets is a central theme of Douglas Baird and Bob Rasmussen's work proclaiming the "end" of bankruptcy. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002). Baird and Rasmussen also emphasize the development of sophisticated financial contracts that can be used to shift control rights outside of bankruptcy. *Id.* at 777-85.

¹⁸ Jared Sandberg & Joann S. Lublin, *Who Runs WorldCom?*, WALL ST. J., Oct. 16, 2002, at B1, B4 (quoting bankruptcy lawyer Evan Flaschen).

A. *Debtor in Possession Financing: Creditors' New Power Tool*

When commentators distinguish Chapter 11 from other countries' corporate reorganization laws, they increasingly point to DIP financing as a crucial benefit of Chapter 11. The magical provision is Section 364,¹⁹ which authorizes the bankruptcy court to roll out the red carpet for a lender that is willing to make a new loan to the debtor. First, the court can treat the DIP loan as an administrative expense, which puts it behind only existing, secured lenders in the priority hierarchy. Second, if the debtor has unencumbered assets, the court can give the DIP lender a security interest in those assets, thus putting the DIP lender on the same footing as the company's secured creditors. Finally, if most or all of the debtors' assets are already spoken for, Section 364 provides its most dramatic option of all: the court can give the DIP lender a so-called "priming lien"—that is, a security interest that takes priority even over existing security interests in the same collateral.

DIP financing dates back well over a century to the equity receiverships that were used to reorganize troubled railroads and that effected the first large-scale corporate reorganizations in America.²⁰ In order to facilitate short-term financing to pay suppliers and other essential creditors, courts created a device known as the "receiver's certificate."²¹ The receiver's certificate gave a special priority—sometimes trumping even senior liens—to investors who contributed new funds to the troubled enterprise.²² This enabled even the most debt-laden railroad to raise money to pay short-term expenses during the reorganization process.²³

¹⁹ 11 U.S.C. § 364 (2000).

²⁰ The emergence of equity receiverships is recounted and explained in SKEEL, *supra* note 6, at 48-70.

²¹ For an example of a court's authorization of the "receiver's certificate" device, see *Meyer v. Johnson*, 53 Ala. 237 (1875).

²² *Id.* at 354.

²³ For a discussion of the role that receiver's certificates played in addressing the debt overhang problem, see, for example, Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 BUS. HIST. REV. 1, 8-9 (1997), which notes that receiver's certificates were a means to raise cash quickly, but did not solve long-term capital needs. During this same era, courts permitted the debtor to pay suppliers in cash, even if senior creditors had a lien on the railroad's income, pursuant to the so-called six months rule. See, e.g., James Byrne, *The Foreclosure of Railroad Mortgages in the United States Courts*, in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, at 77, 124 (1917) (discussing the preferred status generally enjoyed by those claims that accrue

In sharp contrast to today's DIP lenders, the investors who financed receivership certificates did not figure prominently in the governance of the troubled company. Far more important were the company's investment bankers—usually J.P. Morgan; Kuhn, Loeb; or one of a handful of their peers. The investment banks, together with their lawyers, set up committees to represent the stock or bonds they had previously underwritten, negotiated the terms of the restructuring with the debtor's managers, and used the reorganization plan to raise money.²⁴ The standard technique for raising money was to issue new stock and debt in connection with the restructuring. The "purchasers" were the company's existing stock and debtholders, who usually paid a cash "assessment" in return for the privilege of retaining an interest in the reorganized railroad.²⁵

To understand why today's post-petition financiers figure so much more prominently than did their predecessors, the investors in receivers' certificates, we need to add one more historical detail: in the 1930s, as part of their rebellion against Wall Street's influence, the New Deal reformers booted the Wall Street investment banks and lawyers out of the large-scale reorganization practice.²⁶ Chapter X of the Chandler Act, which was drafted largely by future Supreme Court Justice William Douglas, achieved this goal by requiring that the debtor's managers be replaced by a court-appointed trustee and by prohibiting any bankers or lawyers who had represented the debtor prior to bankruptcy from playing any role in the bankruptcy.²⁷ The number of large corporate bankruptcies plummeted,²⁸ and the influence of Wall Street in reorganization disappeared for decades.

Since the 1930s, the financing of large corporate reorganizations has been accomplished primarily through retained earnings and bank

within six months). As with receivers' certificates, the six months rule assured that suppliers would not cut the debtor off. *Id.* at 123.

²⁴ See SKEEL, *supra* note 6, at 58-59 (explaining the role of investment banks in late nineteenth century railroad reorganizations).

²⁵ See, e.g., Tufano, *supra* note 23, at 10-19 (describing the tendency of nineteenth-century federal courts to set low "upset" prices to pressure security holders to agree to pay the assessment).

²⁶ For further discussion of the reforms in bankruptcy law during the New Deal era, see SKEEL, *supra* note 6, at 109-27.

²⁷ Chandler Act of 1938, ch. 575, 52 Stat. 840, 888 (repealed by Pub. L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2549, 2682 (1978)) (requiring a mandatory trustee, as well as attorney, underwriter, and banker disinterestedness); see also 11 U.S.C. §§ 156-58 (2001) (same).

²⁸ See SKEEL, *supra* note 5, at 125 (noting that the number of large reorganizations dropped from more than five hundred in 1938 to fewer than one hundred in 1944).

loans. Because corporate debtors do not have to make ongoing payments on their pre-bankruptcy debt during the case, they may be able to accumulate cash. But they may also need new funding from a bank or other lender, and, even if they don't, the cash coming in is often subject to the security interest of the bank that lent the company money prior to bankruptcy. Therefore, before a corporate debtor can use the new cash, it must obtain a cash collateral order that is designed to protect the bank's interest while the debtor uses the cash.²⁹

Notice the dramatic shift in bankruptcy finance that has taken place. Banks were at the center of the process in the nineteenth and early-twentieth century, and they are at the center of it now. But now we are talking about different banks. In contrast to the equity receivership era, when investment banks ran the show, bankruptcy finance is now the domain of commercial banks.³⁰

In the past decade, post-petition financing has become more important than ever before.³¹ The large firms that filed for bankruptcy in the 1980s often had a large amount of unsecured debt and comparatively little secured debt. As a result, when they filed for bankruptcy, the cash generated by the business was not all spoken for, and the debtor could use this cash to finance the reorganization effort. The large companies that have filed for bankruptcy more recently have often relied more heavily on secured debt prior to bankruptcy, and thus have less cash with which to work. Lenders have responded to the greater importance of post-petition financing and to creditors' concerns about the Chapter 11 process by using the terms of DIP loans to shape the Chapter 11 case.

The financing of the US Airways bankruptcy is a particularly striking illustration of the recent trend. At the outset of its reorganization, US Airways entered into an agreement to borrow up to \$740 million from the Retirement Systems of Alabama—\$240 million up front,

²⁹ See 11 U.S.C. § 363 (2000) (defining the rights and powers of the trustee in liquidation and reorganization cases with respect to the use, sale or lease of property).

³⁰ This is not to say that investment banks have no role in Chapter 11. To the contrary, they figure quite prominently, but they perform functions like consulting on and facilitating asset sales, rather than serving as underwriters. I should also note that the investment banks of the early twentieth century—J.P. Morgan and its peers—also engaged in commercial banking. But their role in corporate reorganization stemmed principally from their investment banking activities.

³¹ For evidence of the increasing use of DIP lending, see, for example, Sris Chatterjee et al., *Debtor-in-Possession Financing* 7 (May 31, 2001) (unpublished manuscript, on file with author), which finds that "[t]he number of firms obtaining DIP financing increased significantly during the 1990s from 27% in the early 1990s to 46% in the late 1990s").

\$300 million during the case, and \$200 million after US Airways was to emerge from Chapter 11.³² The lender assured its influence over the airline's governance and paved the way to take over after bankruptcy, by bargaining for five seats on the twelve-member board of directors and a promise of 37.5% of the stock of the newly reorganized company.³³ The US Airways financing thus was structured as a partial takeover. In many cases, the lender is not planning to take over the company. But even in these cases, the lenders frequently use their DIP financing agreement to constrain the debtor's managers' wiggle room.³⁴ It is not an overstatement to say that the terms of the debtors' post-petition financing regularly set the course, and even the outcome, of the Chapter 11 cases.

B. *Keeping the Managers' Nose to the Grindstone:
Executive Compensation in Chapter 11*

Creditors' other new governance lever has been executive compensation. As with DIP financing agreements, creditors have relied on clear, simple targets to prevent managers from frittering away a company's value during a bankruptcy. Before the managers of a debtor can be encouraged to preserve rather than squander firm value, however, they often must be persuaded to stay.

Managerial compensation arrangements are designed to address each of these issues. Start with managers' willingness to stay with the sinking ship. The payments used to entice managers to stick around

³² See Maynard, *supra* note 16, at C1 (discussing the demand by the Retirement Systems of Alabama, US Airways' chief lender, for labor unions to cut wages and benefits to avoid liquidation of the airline).

³³ *Id.* The Alabama pension subsequently negotiated for control over two more directors (bringing the number to seven) and agreed to lower its equity stake when US Airways emerges to thirty six percent. *Id.*

³⁴ Recent DIP financing agreements have required, for instance, that the debtor sell specified assets or liquidate if they are not generating profits within the first few months of the case. The interim financing agreement in the first FAO Schwartz bankruptcy was a particularly explicit illustration: it called for liquidation, unless the debtor confirmed a reorganization plan by April 4, 2003. See *FAO, Inc.: Reorganization Plan Calls for the Closing of 83 Stores*, CHI. TRIB., Feb. 4, 2003, § 3, at 2 (summarizing FAO Inc.'s reorganization plan and describing how FAO needed court approval of the plan in order to avoid liquidation). More commonly, lenders require that the debtor meet specified cash flow targets as a prerequisite to further extensions of credit under a revolving credit agreement. In the United Airlines bankruptcy, for instance, these cash flow targets were designed to force United to extract deep concessions from its unions. See Marilyn Adams, *Low-Cost Carrier Plan Trips Up UAL*, USA TODAY, Mar. 14, 2003, at 3B (describing how United planned to break labor contracts to meet cash flow targets set by lenders).

during a bankruptcy are usually referred to as "retention bonuses" or "pay to stay."³⁵ It is not hard to appreciate why a debtor's managers might welcome the "pay to stay" strategy; indeed, the debtor's managers are ordinarily the ones who put forward the proposal. From the creditors' perspective, on the other hand, the decision to approve these bonuses is more complicated. After all, there is something a bit odd about begging the same managers who navigated the firm into bankruptcy to keep up the good work. Despite their reservations, however, creditors increasingly have concluded that they are better off paying to keep the debtor's existing managers in place.³⁶ These managers know the business best, and the process of hiring new managers and bringing them up to speed could prove time-consuming and disruptive. According to one compensation expert, "[t]he wide use of pay-to-stay bonuses is a shift from the last economic slowdown in the early 1990s"³⁷ Although retention bonuses were used in a few cases (such as the Federated Department Stores bankruptcy) in the late 1980s and early 1990s, "creditors warmed to the idea on a larger scale after watching retail and electronics-chains suffer through major executive flight."³⁸

Nearly all of the mega-bankruptcies of the past several years have made use of retention bonuses (though they have generated controversy at times). In WorldCom, for instance, the debtor asked for and received court approval of a plan to use up to \$25 million to pay bonuses ranging from \$20,000 to \$125,000 to 329 of WorldCom's key employees.³⁹ Courts approved analogous bonus programs in the Enron and Kmart bankruptcies.⁴⁰

³⁵ See, e.g., Ann Davis, *Want Some Extra Cash? File for Chapter 11*, WALL ST. J., Oct. 31, 2001, at C1 (reporting the popularity of "retention" and "pay to stay" bonuses in recent restructuring cases).

³⁶ In some recent cases, the managers are executives who were brought in before bankruptcy or shortly after the filing to help restructure the company.

³⁷ Davis, *supra* note 35, at C1 (quoting David R. Williams, a restructuring and executive pay expert with PricewaterhouseCoopers).

³⁸ *Id.*

³⁹ Rebecca Blumenstein, *WorldCom Judge Approves Plan to Keep Employees*, WALL ST. J., Oct. 30, 2002, at B3.

⁴⁰ See Yue *infra* note 42, at 1A (describing the Kmart bonus plan to retain its chairman and chief executive, Jim Adamson); Ahrens, *infra* note 43, at D13 (describing the Enron bonuses). In some cases, creditors have agreed to foot the bill for retention bonuses directly. In the Washington Group International (WGI) bankruptcy, the debtor's lenders agreed to fund bonuses for 490 key employees (some of whom could receive as much as \$29 million) in return for all of the stock in a new company that would acquire WGI's assets. Although the plan created consternation among WGI employees who were not included in the plan, the court approved the bonus plan.

Now, simply paying managers to stay does not necessarily ensure they will reorganize the company efficiently.⁴¹ This is where pay-for-performance, the second new innovation in bankruptcy compensation, comes into play. Rather than paying managers a straight cash salary in Chapter 11, creditors have insisted in recent cases that the managers' compensation be tied to the company's progress under Chapter 11. The most straightforward strategy for rewarding managers who handle the case expeditiously is to base their compensation, at least in part, on the speed of the reorganization.⁴²

Another pay-for-performance strategy comes into play if the debtor is expected to sell some or all of its assets in connection with the Chapter 11 case. Creditors can maximize the managers' incentive to obtain the highest price possible by giving them a piece of the action, and this is exactly what they have done in a number of recent cases. In the Enron bankruptcy, for instance, the compensation scheme is designed to give the managers bonuses for quickly selling the debtor's assets.⁴³ In other cases, managers' bonuses have been based not on the speed, but on the price they obtained in the asset sale.⁴⁴

See Richard Korman, *Pay-to-Stay Plan Miffs Employees*, ENGINEERING NEWS-RECORD, June 18, 2001, at 12 (discussing the court-approved WGI bonus plan, which offered bonuses to select employees); see also Cynthia Vinarsky, *Youngstown WCI to Idle Sinter Company Plant*, VINDICATOR (Youngstown), May 1, 2001, at A1 (noting a promise by lenders to pay bonuses in connection with liquidation of CSC Ltd.).

⁴¹ Unless the bonuses are paid out in installments, it does not even ensure that they will stay, as we learned at the outset of the Kmart bankruptcy. See, e.g., Hawke Fracassa & Karen Talaski, *Kmart Investigates Its Former Executives*, DETROIT NEWS, May 3, 2002, at A1 (describing a Kmart merchandising executive who received a \$750,000 retention loan, then left the company).

⁴² WorldCom's retention bonus plan, for instance, provides for "Plan Progress Bonuses" that start out at 10% of the value of the initial retention bonus. Under the plan, key employees are entitled to 100% of the progress bonus if a reorganization plan is confirmed in December 2003, 150% for a November 2003 confirmation, 200% for an October 2003 confirmation, and 250% for confirmation by September 30, 2003. Motion of the Debtors Pursuant to Sections 363(b) and 105(a) of the Bankruptcy Code for Authorization to Establish a Key Employee Retention Plan at 6-7, *In re WorldCom, Inc.*, 296 B.R. 115 (Bankr. S.D.N.Y. 2003) (No. 02-13533); see also Lorene Yue, *Kmart Lines Up Cash for New Boss*, DETROIT FREE PRESS, Apr. 5, 2002, at A1 (discussing request to approve two year contract that would include \$2.5 million signing bonus, \$1 million in salary per year, and \$4 million bonus if reorganization was completed by July 31, 2003; the bonus would decrease by \$7299 per day thereafter, and disappear if Kmart failed to emerge by April 30, 2004).

⁴³ See, e.g., Frank Ahrens, *Enron Files for New Bonuses, Severance*, WASH. POST, Mar. 30, 2002, at D13 (discussing proposed bonuses for quickly selling assets).

⁴⁴ See, e.g., E-mail from William H. Schorling, Shareholder, Klett, Rooney, Lieber & Schorling, Corp., to David A. Skeel, Jr., Professor of Law, University of Pennsylvania

* * *

We do not expect to see both of these new governance strategies at work in every given case. DIP financing is more likely to be used as a governance lever when there is a takeover offer on the table or it is clear which divisions a debtor needs to sell. To give the most striking recent example, the DIP financing of Trans World Airlines (TWA) was conditioned on the prompt consummation of TWA's acquisition by American Airlines.⁴⁵ Where the direction is less obvious, as in the WorldCom bankruptcy, creditors are less likely to dictate the course of the case through the DIP financing agreement, and are more likely to lean on pay-for-performance strategies as the principal mechanism for moving cases along.

It is also worth emphasizing that the "creditors" involved in DIP financing overlap with—but are not identical to—the ones that help hammer out the terms of managerial compensation. DIP financing comes from one or a small group of lenders who can impose explicit governance conditions on their lending.⁴⁶ With managerial compensation, on the other hand, creditors generally work through the creditors' committee as a whole, and their influence is not quite so direct. The debtor-in-possession, rather than the committee, is usually the one that asks the court to approve a pay or bonus package. But the creditors' committee's fingerprints are all over the proposal. The pay package is typically prenegotiated with the committee, and the debtor's managers will be hesitant to file the motion for approval unless the committee is on board.⁴⁷

One last caveat: the creditors' committee obviously is not involved—by definition, it does not even exist yet—if the debtor decides

(Dec. 20, 2003. 11:17:47 EST) (on file with author) (noting that bonuses were keyed to asset sales in the Matlack and Printing Arts cases, and that this is common with key Employee Retention Plan bonuses).

⁴⁵ See Susan Carey, *American Airlines' TWA Financing Plan is Approved, Although Rivals Cry Foul*, WALL ST. J., Jan. 29, 2001, at A3 (reporting on American Airlines' acquisition of TWA).

⁴⁶ See Chatterjee et al., *supra* note 31, at 11 (finding that ninety percent of DIP loans impose explicit restrictions on the debtor's operating activities). DIP lenders also force changes—and sometimes effect a "slow liquidation"—through their control over subsequent loan disbursements. See *id.* at 3 (claiming that DIP lenders are active in monitoring firms and forcing changes).

⁴⁷ Major creditors or the creditors' committee itself sometimes object to proposed compensation packages, but these objections are lodged for strategic reasons or because of a breakdown in the discussions on the pay package, not because creditors disapprove of performance based pay. Interview with Bill Schorling, Partner, Klett, Rooney, Lieber & Schorling, in Philadelphia, PA (Dec. 18, 2002).

to dole out retention bonuses before it files for bankruptcy. A complete account of the new governance levers will need to take eve-of-bankruptcy compensation into account, too, so I will throw this into the mix when we return to the issue in Part IV.

C. *Who's on First? Controlling the Board of Directors in Chapter 11*

I have assumed throughout much of the discussion that the creditors have an arm's length relationship with the managers of the debtor. But do they? If creditors can determine who is or is not on the debtor's board of directors, they will find it much easier to shape the company's governance in Chapter 11. The issue of who controls the managers and board of directors in Chapter 11 is more interesting, and less clear, than first meets the eye.

Not so long ago, most observers assumed that a company's directors were, or at least should be, beholden to the company's shareholders in Chapter 11, just as they are outside of bankruptcy. Based on this reasoning, shareholders sometimes asked for the right to hold a shareholders' meeting in order to elect a new set of directors during the Chapter 11 case.⁴⁸ Courts were generally sympathetic to these requests, except in cases where the shareholders seemed intent on derailling the reorganization process. The related issue of whether existing directors continue to listen to shareholders, or turn their ears to creditors, after the company files for bankruptcy is more subtle; it is not always easy to determine a director's loyalties, and the empirical data are mixed. While directors sometimes seem to take their cues from shareholders, this was not always the case.⁴⁹

In the early years of the new millennium, many observers have forgotten all about the old assumption that shareholders call the directorial tune in Chapter 11. Observers sometimes assume, for instance, that a new manager cannot be brought on without the creditors' "approval." Strictly speaking, this is not true. Creditors' powers

⁴⁸ For a discussion of the cases, and a defense of shareholders' right to hold a meeting during bankruptcy, see Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should the Meeting be Cancelled Altogether?*, 58 GEO. WASH. L. REV. 1214, 1227-30 (1990). For an argument that shareholders generally should not have this power, see Skeel, *supra* note 8, at 505-13.

⁴⁹ See, e.g., Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Corporations*, 141 U. PA. L. REV. 669, 672 (1993) (noting that directors sometimes serve the interests of their creditors rather than their shareholders).

are much less direct. To appreciate the precise nature of creditors' influence, as well as its limits, we should briefly consider the leverage creditors have at their disposal.

Even before bankruptcy, in cases involving DIP financing, the DIP lender often insists that a restructuring officer be brought in as a condition of providing the new financing. The not-so-subtle message is this: unless the managers agree to additional oversight, they won't get the loan.⁵⁰

Creditors have two principal ways to influence the board once the debtor files for bankruptcy. First, creditors can threaten to ask the court to appoint a trustee unless the CEO or one or more board members is replaced by a manager—often a corporate restructuring officer—who is more acceptable to the creditors.⁵¹ This is a powerful threat, but it is also both blunt and indirect. Replacing the debtor's managers with a trustee is a draconian step—a step that courts are quite reluctant to take in the absence of fraud or other extraordinary circumstances. Nor, in most cases, do creditors really want a trustee, since the case would slow to a crawl while the trustee educated herself about the debtor's business. The credibility of the creditors' threat (as in all games of "chicken") therefore depends on their confidence that the debtor's directors are more worried about the appointment of a trustee than are the creditors.

The creditors' second strategy is—as noted at the outset of this Part⁵²—to make clear to the directors that the creditors are the ones who will be holding the company's stock after the reorganization, and that they intend to dump any recalcitrant directors once they take over.⁵³ This threat is more direct, but it is also rather distant if the reorganization process is going to be lengthy.⁵⁴

⁵⁰ For a similar point, see Baird & Rasmussen, *supra* note 17, at 784 ("Most large firms that enter Chapter 11 lack enough free cash flow to operate without [DIP] financing."). As noted earlier, some lenders insist on direct board representation. *See, e.g.,* Maynard, *supra* note 16, at C2 (reporting that US Airways' chief lender will receive increased board representation once the company emerges from Chapter 11).

⁵¹ 11 U.S.C. § 1104 (2000).

⁵² *See* Sandberg & Lublin, *supra* note 18 and accompanying text.

⁵³ Shareholders sometimes receive a limited equity interest in the reorganized company, but most of the equity goes to the company's creditors. *See, e.g.,* Lynn M. Lopucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 143 (1990) (discussing data on dividing a reorganizing enterprise's value among various claims and interests).

⁵⁴ Creditors could also object to proposed compensation for disfavored directors or refuse to vote for confirmation of a reorganization plan that does not bring in new management. But there are obvious limitations to each of these strategies. Their

In the absence of a direct way for creditors to take control of the board, directorial norms play a crucial role in Chapter 11 governance. To the extent creditors now have implicit veto power over directorial changes, this influence suggests that directorial norms have shifted as creditors have made increasing use of DIP financing agreements and tailored compensation arrangements.⁵⁵

One interesting and important effect of Enron, WorldCom, and the other recent headline cases is that they could powerfully reinforce the norm of directorial responsiveness to creditors, and particularly to creditors' calls for them to step down. Recall my prior statement that courts are reluctant to appoint a trustee in the absence of fraud or gross misconduct. Although the mega-bankruptcies of the 1980s and early 1990s usually did not involve obvious, pervasive fraud, the most spectacular recent cases are quite different. Just tick down a list of the cases—Enron, WorldCom, Global Crossing, Adelphia—to see that each is saturated in fraud. As a result, the creditors' threat to call for a trustee is far more potent than in previous years,⁵⁶ and it seems quite likely that these cases will color the thinking of courts and directors for years to come. If courts are more willing to appoint a trustee (or if the parties *think* the court would be more sympathetic to such a request), we can expect directors to listen even more closely to creditors' demands, even in cases that do not look remotely like Enron or Global Crossing.

There is an obvious analogy between directors' heightened responsiveness to creditors in Chapter 11 and the recent debate in corporate law about staggered boards⁵⁷—that is, boards that are divided into three or more classes of directors, only one of which comes

objections may be rejected and confirmation threats amount to another game of chicken; creditors will be hurt if the case drags on. See Lopucki & Whitford, *supra* note 49, at 693-94 (describing the disadvantages to creditors brought on by a directorial delay of reorganization).

⁵⁵ For a discussion of the shift in norms for directorial performance outside of bankruptcy over the past several decades, which emphasizes the new expectation that directors engage in meaningful oversight, see Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1265 (1999).

⁵⁶ Enron is perhaps the best illustration. Enron's board and its bankruptcy lawyers were rumored to have agreed to give the creditors' committee veto power over all major decisions, due in large part to the parties' assumption that the court would quickly appoint a trustee if asked. See, e.g., Rebecca Smith & Mitchell Pacelle, *Enron Plans to Return to Its Roots: Draft Proposal to Creditors Envisions a Smaller Firm Focused on Hard Assets*, WALL ST. J., May 2, 2002, at A1, A6 (referring to the enormous influence of Enron's creditors over the bankruptcy reorganization).

⁵⁷ Thanks to Jesse Fried for encouraging me to pursue this analogy.

up for reelection in any given year. If a company has an effective staggered board, an outside bidder cannot take control even if she wins a proxy fight at the next annual meeting.⁵⁸ Since only one-third of board seats are in play each year, it takes two elections to acquire control. In the past, the remaining directors generally stepped down after the bidder took one-third of the seats; they assumed that there was no point in sticking around, since the outside bidder would be in charge after the next election. For the past decade, however, firms have been able to combine their staggered board with a poison pill. The poison pill prevents the bidder from acquiring a majority of the firm's stock and thus makes it hard for the bidder to demonstrate control after it wins the initial proxy contest.⁵⁹ In these cases, a different directorial norm may be taking hold; the existing directors often seem inclined to stick it out, rather than resigning to let the bidder take over.⁶⁰

Given the vast number of consensual takeovers in the late 1990s, we shouldn't draw sweeping conclusions about the extent to which staggered boards interfere with takeovers. But the effect of staggered boards on directorial acquiescence to bidders outside of bankruptcy underscores—by way of contrast—just how much bankruptcy governance has changed in recent years. A decade ago, I and other commentators analogized Chapter 11 to an antitakeover device—a mechanism that helped managers to entrench themselves, at least for a while.⁶¹ The new norm in bankruptcy, by contrast, is for directors to accede to a change in control, rather than to resist.

⁵⁸ For a discussion and a thorough analysis, see Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 902-24 (2002). "[S]taggered boards are in fact extremely potent as an antitakeover device." *Id.*

⁵⁹ *Id.* at 905 ("[T]he pill provides an impenetrable barrier to control acquisitions.").

⁶⁰ The most prominent counterexample seems to be that of Weyerhaeuser Co.'s hostile bid for Willamette Industries, Inc., where the Willamette board stepped down after Weyerhaeuser won the initial proxy contest. *Id.* at 928 & n.127 (quoting *Willamette Industries Inc.: Weyerhaeuser Slate Gains Seats on Company's Board*, WALL ST. J., July 17, 2001, at C13; Jim Carlton & Robin Sidel, *Willamette Agrees to be Bought by Weyerhaeuser*, WALL ST. J., Jan. 22, 2002, at A3).

⁶¹ See, e.g., David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 535 (1994) ("Like an antitakeover device, bankruptcy can impair the market's ability to discipline managers because it may substitute reorganization procedures for market mechanisms that would otherwise lead to the ouster of managers outside of bankruptcy." (footnote omitted)).

II. THE VIRTUES OF THE "NEW" NEW BANKRUPTCY GOVERNANCE

Having described the effects of creditors' new governance levers, let me begin the normative phase of my analysis with a few words of praise. I will devote much more of my attention to possible problems with the recent changes, but it is worth emphasizing that their overall effect is both encouraging and exciting. The developments we have witnessed in the past decade should be seen as a step in the right direction.

We need only recall the concerns of the 1980s and early 1990s to appreciate the systemwide benefits of creditors' increased influence over bankruptcy governance. No longer do we hear complaints about endless extensions of the debtor's exclusivity period and cases that go on forever. Nor do debtors' managers cling to highly unrealistic hopes of reorganizing the firm in essentially its existing form: the terms of the debtor's post-petition financing force it to sell assets that are worth more in a buyer's hands, and performance-based executive compensation arrangements encourage managers to move more briskly through the Chapter 11 process. Now, it is in the managers'—not just creditors'—interests to reorganize as promptly as possible.

To this point, I have focused almost entirely on the ex post effects of the creditors' new governance levers, their effect once the company has encountered financial distress. But these levers have attractive ex ante effects as well. An important benefit of the deviations from absolute priority made possible by Chapter 11 is that they encourage managers of a troubled firm to file for bankruptcy, rather than delaying as long as possible and destroying value as they fend off the inevitable.⁶² But the prospect that shareholders will receive something, even if the firm fails, gives managers and shareholders an incentive to take excessive risks while the company is healthy.⁶³

If used effectively, the creditors' new governance levers can preserve the ex ante benefit of deviations from absolute priority while reducing their downside. Overall, they diminish the likelihood of deviations from absolute priority by reining in the debtor's managers. At

⁶² See Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 169-74 (1989) (discussing eve-of-bankruptcy conflicts of interest that were present before the recent changes in Chapter 11 governance).

⁶³ See Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 473 (1992) (asserting that during periods of debtor solvency, "bankruptcy allocation increases management's incentives to take undue risks with the debtor's assets on equity's behalf").

the same time, managers know they will be paid well in Chapter 11 if creditors view them as part of the solution to the company's woes, rather than as emblematic of its problems. The knowledge that they will be reassessed at the outset of the bankruptcy case may make managers less anxious to take value-destroying risks while the company is still solvent. To be sure, there is a risk that managers will respond by pursuing projects for which they are indispensable. But the existing evidence suggests that there may be limits to managers' abilities (and perhaps even their inclination) to entrench themselves in this fashion.⁶⁴

At its best, then, the "new" new bankruptcy governance offers a simple and dramatically effective market-based response to the problems that plagued large-scale corporate reorganization a decade ago.

III. TOP HEAVY: THE DOWNSIDES OF THE DIP FINANCING LEVER

Chapter 11's generous treatment of DIP financing raises closely related concerns, which stem from the priority status of this interim financing. The first and most obvious concern—the one prior commentators have tended to emphasize—is the possibility that DIP financing will promote overinvestment.⁶⁵ The risk of overinvestment is the dark side of DIP financing's principal benefit that super-priority can counteract creditors' unwillingness to fund even desirable projects if the borrower is insolvent. Although DIP financing makes it possible to fund positive present value projects, thus solving a debtor's underinvestment problems, it can also be used to fund negative present value projects, since the lender is protected by its priority status in both contexts.

The question raised by the overinvestment concern is whether courts or other decision makers can distinguish between good DIP financing arrangements (the underinvestment context) and bad ones (the overinvestment context), and thus maximize the benefits of DIP

⁶⁴ For a fascinating study that finds evidence to suggest the existence of limits on managers' abilities to entrench themselves within Sweden's automatic auction bankruptcy regime, see B. Espen Eckbo & Karin S. Thorburn, *Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions*, 69 J. FIN. ECON. 227, 244 (2003).

⁶⁵ The best analysis of this issue, and still the leading article on DIP financing, is George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993) (suggesting that bankruptcy courts can counteract underinvestment problems, while minimizing the risk of overinvestment, through their decisions to allow or disallow proposed DIP financing arrangements).

financing and control its costs.⁶⁶ The principal focus here is on screening—the initial decision whether, and on what terms, to authorize the DIP financing. But the growing use of DIP financing as a governance lever has underscored the fact that the DIP lender is not simply a passive supplier of capital.⁶⁷ Its heightened prominence in major cases raises a second issue: to the extent they are calling the shots, or helping to call the shots, do DIP financiers have appropriate decision making incentives during the Chapter 11 case? I will start with this question and then return to consider some of the problematic terms that are currently being included in DIP financing agreements.

To assess DIP lenders' role in Chapter 11 governance, it is useful to begin by contrasting today's lenders to the investment banks that played a similarly central role in the old equity receivership era. In the early twentieth century, J.P. Morgan and Kuhn, Loeb & Co. represented shareholders and bondholders and often emerged from the restructuring holding a chunk of the debtor's debt and stock.⁶⁸ As a

⁶⁶ Although many commentators have argued that DIP financing leads to inefficient continuation of economically distressed companies and, thus, that overinvestment is a serious problem, the empirical evidence is more encouraging. Recent studies suggest that cases with DIP financing are more likely to lead to reorganization and are resolved more quickly than cases without DIP financing. See, e.g., MARIA CARAPETO, DOES DEBTOR-IN-POSSESSION FINANCING ADD VALUE? (LBS Inst. of Fin. & Acct., Working Paper No. 294-1999, forthcoming 2004) (manuscript at 35, Oct. 6, 2003) (studying publicly traded companies that filed for bankruptcy during 1986–97 and concluding that “post-petition loans are associated with a greater possibility of successful reorganization”), available at <http://www.cass.city.ac.uk/faculty/mcarapeto/index.html>; Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 270-76 (2003) (finding that DIP financing increases a firm's chances of emerging successfully from Chapter 11 in a sample taken from all Chapter 11 cases filed from 1988–97); see also Chatterjee et al., *supra* note 31, at 15-16 (finding that firms increase in stock and public debt value when DIP financing is approved).

⁶⁷ Commentators have long been aware that banks play an important role in the insolvency context. See, e.g., Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders*, 27 J. FIN. ECON. 355, 356 (1990) (describing the influence of banks on composition of board of directors and other internal structural issues). My point is simply that lenders have ratcheted up their role in large Chapter 11 cases in the past few years. For a somewhat similar perspective, see Chatterjee et al., *supra* note 31, at 3, which emphasizes the monitoring role played by DIP lenders, in addition to the “certification” they provide of debtor quality.

⁶⁸ Although the bank usually had a minority stake, it often controlled the governance of the reorganized firm, at least initially, pursuant to a voting trust arrangement set up as part of the reorganization plan. See, e.g., 5 ARTHUR STONE DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 168-69 (1920) (describing the frequency of bankers' governance of a reorganized firm while giving stockholders a new contingent charge security); see also Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV.

result, J.P. Morgan acted more like a residual claimant of the firm's assets than, say, Citigroup now does.⁶⁹ It benefited directly if the reorganized debtor succeeded, and suffered if the company did poorly. Moreover, because Morgan wished to persuade investors to buy the bonds it underwrote in the future, it also had a reputational stake in the success of the company.

Things look rather different from the modern DIP financiers' secure perch at the top of the priority ladder. Because they face^a a downside risk if the debtor's fortunes are volatile,⁷⁰ but their upside potential is fixed, DIP financiers have an incentive to minimize volatility and to compress the debtor's risk profile.⁷¹ In Chapter 11, the simplest way to do this is to convert most or all of the debtor's assets to cash through sales. It is important not to overstate the point. If the debtor's business is truly viable, and the lender hopes to continue its lending relationship with the firm, the desire for future business will counteract the impulse toward liquidation. If the debtor is not viable, on the other hand, liquidation may be just what the doctor ordered. On the margin, however, there is a risk that DIP lenders will put pressure on the debtor to liquidate too many assets prematurely if they are calling the shots.

921, 930-36 (2001) (outlining the role of investment bankers in the reorganization and recovery process during the age of J.P. Morgan and the reliance on equity receivership).

⁶⁹ J.P. Morgan may have had a greater commitment to the debtor's bonds than to its stock. See, e.g., Tufano, *supra* note 22, at 29 (noting that the voting trusts used by J.P. Morgan and other banks to maintain control after the reorganization "were formally initiated by shareholders, [but] in practice they usually were more concerned with protecting bondholder interests"). But it still had much less of a tendency toward risk aversion than most contemporary DIP financiers. For evidence that DIP lenders often are not residual owners, yet exercise control in current cases, see Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study* 21 (Apr. 29, 2003) (unpublished manuscript, on file with author).

⁷⁰ The most dramatic illustration of this downside risk is Winstar, whose DIP lender supplied \$225 million in financing, but realized only \$42.5 million when Winstar's principal assets were sold. Winstar's ensuing legal wrangling, and the efforts of creditors to recover, are documented in *United States v. Winstar Corp.*, 518 U.S. 839 (1996). Lenders often point to the Winstar debacle as a justification for the extra protections (such as insulation from preference actions) they demand as part of the DIP financing agreement. In most cases, however, DIP lenders are unlikely to face this kind of risk. See, e.g., LoPucki, *supra* note 69, at 21 (arguing that "in the large majority of the cases studied[,] DIP lenders were "protected by substantial cushions of equity").

⁷¹ One partial exception to this statement is DIP lenders who use DIP financing to take control of the debtor. For discussion of the concerns raised in this context, see *infra* note 74 and accompanying text.

The debtor's managers might seem to have an incentive to minimize the risk of an overweening DIP lender when they agree to the terms of the DIP financing before bankruptcy. But managers are likely to focus more on giving themselves one last chance than on obtaining the optimal financing terms.

To the extent DIP lenders become too quick to liquidate, this impulse could not only lead to inefficient liquidation; it could undermine a salutary effect of large scale Chapter 11 cases that I will refer to as the "antitrust benefit." What I mean by "antitrust benefit" is simply that the failure of a prominent company can roil the competitive structure of an industry. If the industry is already relatively concentrated, the disappearance of a major company might leave a small number of companies that have significant market share. In the airline industry, for instance, if United, US Airways, and perhaps one or two of the other troubled airlines were liquidated or absorbed into their healthier peers, the industry could become increasingly monopolistic. By providing a way for existing companies to reorganize in stand-alone form, Chapter 11 supplies a benefit that has received surprisingly little attention from bankruptcy commentators.⁷² Further, once we focus on the antitrust benefit of Chapter 11, it immediately becomes apparent that recent complaints that WorldCom and other firms have gotten an unfair competitive benefit from bankruptcy are misguided.⁷³

If Chapter 11 was replaced with, say, mandatory auctions, the antitrust benefit could disappear. In an auction, the most likely bidders

⁷² It is important to note that even if DIP lenders had an incentive to maximize the value of the debtor, this would not give them an incentive to protect the antitrust benefit. The antitrust benefit is a positive externality created by Chapter 11—a social benefit rather than a benefit to the firm itself. In contrast to this positive externality, bankruptcy also produces negative externalities in at least one critical area: the rules for assumption and rejection of contracts give the debtor an incentive to reject contracts that are socially desirable. See Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1831-38 (2002) (discussing insolvent firms' tendency to underinvest in potentially lucrative contracts).

⁷³ See, e.g., Simon London, *Critics Are Hoping It Could be End of Story for Chapter 11*, FIN. TIMES, Dec. 20, 2001, at 22 (quoting Verizon CEO's complaint that WorldCom and Global Crossing can "use Chapter 11 'to cleanse their sins, then drive prices down'"). While WorldCom's competitors would prefer that WorldCom be dismembered, the loss of a major player would significantly increase industry concentration.

Another complaint is that companies that have been reorganized will have so much less debt that they will have a competitive advantage over the other companies in their industry. But if having less debt is attractive, the competitors can simply issue more stock and use the proceeds to retire debt.

are other companies in the same industry. This is not always the case, of course, but in an auction regime, regulators would more frequently be faced with the decision whether to exclude industry bidders (and perhaps set the stage for piecemeal liquidation as a result) or to permit an industry bid that could ratchet up industry concentration.

To this point, I have lingered over the troublesome incentives of a DIP lender who faces at least some downside risk. However, if the lender is fully protected, there is a different concern: although a fully protected lender is less likely to have a bias toward liquidation, it may, in a sense, be indifferent to the fate of the firm. After all, the lender's collateral assures that it will get paid even if Chapter 11 fails to produce a sensible allocation of the debtor's assets. Once again, I do not want to overstate my point. In an increasingly competitive DIP financing market, lenders would not want to earn a reputation for regularly presiding over needlessly sinking ships. And a lender that wishes to continue lending to the debtor after bankruptcy, as a significant number of DIP lenders do, will have at least some concern for maximizing the value of the debtor's assets. But the lender's protected status puts it in a very different position than J.P. Morgan and its peers in the old equity receivership days. A fully protected bank has a much more attenuated stake in the effectiveness of the restructuring process.

A final issue is the use of DIP financing agreements to bring about a takeover of a Chapter 11 firm. While these transactions are grounds more for applause than for concern, there is a risk that a takeover bidder that enters the picture as a source of DIP financing will use the DIP financing agreement to effectively preclude other bidders. In these cases, the DIP financing agreement may serve not just to cause a change in control, but also to dictate its terms.⁷⁴

So, just how serious are these concerns? Overall, the emergence of DIP financing agreements as a central text of Chapter 11 is a welcome advance, for all of the reasons I briefly described in the last part. But, in at least some cases, the fetters are too tight; the restrictions enshrined in the DIP financing agreement will have perverse effects as the case progresses.

⁷⁴ The most prominent current example is US Airways. As discussed earlier, *see supra* note 33 and accompanying text, Retirement Systems of Alabama negotiated for the right to appoint seven directors and for thirty-six percent of the stock of the reorganized airline. The agreement effectively dictated the shape of the US Airways reorganization.

How might we address these downsides of the DIP financing lever? Let me suggest and critique three possible responses, starting with the most dramatic. The first option is to rethink the way corporate debtors finance their reorganization effort. As we have seen, post-petition lenders (i.e., the holders of receivers' certificates) had very little role in corporate governance during the equity receivership era. One way to edge back in this direction and curb the influence of DIP lenders would be to sharply restrict the scope of DIP lending and force the debtor to fund the reorganization through new financing (such as selling stock or debt) at the confirmation of the bankruptcy case.

Although shifting the focus from commercial to investment banks would be quite attractive in some contexts, it has serious shortcomings as a general response to DIP lenders' suboptimal decision-making incentives in large Chapter 11 cases. The most important problem is simply that it would be quite difficult to stuff the genie back in the bottle. Investment bankers no longer play the active oversight role they did in the J.P. Morgan era, and commercial banking has evolved to fill that vacuum. An additional problem is that bank borrowing often makes more sense than issuing public debt when a company emerges from bankruptcy, given the likelihood that the ownership structure of the reorganized firm will be concentrated.⁷⁵

The second strategy would be to subject the DIP lending to a vote of the firm's general creditors, since the general creditors are likely to be the party with the best decision-making incentives. One way to structure the vote would be to permit the court to authorize the initial DIP financing at the outset of the case, then require creditor approval if the debtor wishes to increase the scope (either in amount or duration) of the financing arrangement.⁷⁶ Although creditor voting is

⁷⁵ If a company has concentrated equity, concentrated debt (such as a bank loan) is generally a more cost-effective source of funds than diffuse debt (such as bonds), due to agency cost problems created by the mismatch between concentrated equity and diffuse debt. See John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1763-67 (2002) (discussing the benefit of matching concentrated equity and concentrated debt).

⁷⁶ The timing of the two-step sequence would be somewhat similar to the approach many bankruptcy courts currently use. These courts give initial approval to DIP financing almost immediately, and then hold a formal hearing thereafter. Creditors have the right to object to the DIP loan at the hearing, but they do not have authority to approve or reject as they would under creditor voting.

The creditor-voting concept has received substantial attention in the sovereign debt context. See, e.g., WILLIAM W. BRATTON & G. MITU GULATI, SOVEREIGN DEBT

more realistic, it too has important downsides. Holding a vote during the early stages of a Chapter 11 case would be quite cumbersome, for instance. And if creditors could be expected to vote down (or force renegotiation of) a nontrivial number of DIP lending proposals, DIP lenders might be reluctant to commit to the financing *ex ante*.

The third, and most realistic, response is to continue to rely on *ex post* oversight by the bankruptcy court. Many bankruptcy judges already leave themselves leeway to change course on a DIP financing agreement they previously approved.⁷⁷ Under extraordinary circumstances, a court might refuse to enforce a DIP financing provision according to its terms.⁷⁸ More importantly, a more fine-tuned inquiry when the DIP financing is first proposed could eliminate some of the most obvious current abuses. When the debtor turns to an existing lender for DIP financing, for example, courts have sometimes approved loan agreements that protect the lender against possible preference actions. The shield against preference will often improve the status of the lender's prepetition loan, converting it from potentially unsecured to fully secured, which raises serious overinvestment concerns.⁷⁹ The obvious solution to this problem is for courts to refuse to permit these protections, as most courts now refuse to

RESTRUCTURING AND THE BEST INTEREST OF CREDITORS 3-6 (Geo. Wash. Univ. Law Sch., Pub. Law Research Paper No. 59, Geo. Law & Econ. Research Paper No. 387880, 2003) (on file with author) (proposing creditor vote as a means of facilitating interim financing). For a variation, see Patrick Bolton & David A. Skeel, Jr., Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured? 47-50 (Apr. 2, 2003) (unpublished manuscript, on file with author), which argues for court approval of limited interim financing, with creditor vote required for larger loans.

⁷⁷ See, e.g., Judge Peter J. Walsh, Open Letter to the Delaware Bankruptcy Bar re: First Day DIP Financing Orders, ¶ 13 (April 2, 1998), in Marcus Cole, *Delaware Is Not a State: Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845, 1914 app. A (2002) ("The period of time during which the creditors' committee should have the right to challenge the lenders' prepetition position should generally be at least sixty days from the appointment of the committee.").

⁷⁸ If the agreement requires that a key division be sold unless it is cash flow positive within ninety days, for instance, a court might hold the DIP lender at bay if, after ninety days, the sale seemed likely to undermine the restructuring effort. But it should be noted that there is a strong presumption against undoing the terms of a DIP financing agreement. See, e.g., 11 U.S.C. § 364(e) (2000) ("The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt . . . does not affect the validity of any debt so incurred . . .").

⁷⁹ The concern is that the added protection will facilitate borrowing to finance value-decreasing projects, such as the continuation of a business that should be liquidated. For an extensive discussion examining the effect that giving preferences to certain creditors in bankruptcy has on dynamic asset pools, see Barry E. Adler, *A Re-Examination of Near Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575 (1995).

permit so-called cross collateralization provisions.⁸⁰ Similarly, courts should refuse to authorize roll-up transactions that protect a DIP financier's pre-petition lending unless it is clear that the pre-petition loan is fully secured.⁸¹

Notice that the approach I have just outlined is a bit of a double-edged sword. Limiting the scope of the DIP lending agreement may increase the risk that the DIP lender later will become undersecured, and thus exacerbate the lender's incentive to push for liquidation. Lenders are likely to adjust to this risk, however, by limiting their lending ex ante. It is the benefits of these ex ante adjustments that justify closer scrutiny of the provisions DIP lenders are currently trying to sneak into their lending agreements.

Provisions that bring about a change of control by promising the lender a specified equity interest in the reorganized debtor are a trickier issue. One attraction of this arrangement is that it gives the lender a direct stake in the outcome of the reorganization, thus addressing the problem of DIP lenders' priority status. But the equity guarantee is quite similar to a stock lockup of the sort that would be unenforceable outside of bankruptcy.⁸² For similar reasons, the promise of a voting stake should be prohibited in bankruptcy.

In short, courts should be especially wary when the debtor obtains DIP financing from an existing lender and should invalidate provisions that enhance the status of a prepetition loan. Provisions that lock in a change of control and stiff arm alternative bidders are also suspect. In each case, judicial discretion is likely to be the simplest and most realistic device for responding to the concerns posed by existing DIP financing agreements.

⁸⁰ Cross collateralization provisions secure not only the lender's post-petition loans, but also unsecured (or undersecured) advances the lender made prior to bankruptcy. The leading case on these provisions is *Shapiro v. Saybrook Manufacturing Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1495 (11th Cir. 1992), which concludes that cross-collateralization is not authorized by the Bankruptcy Code.

⁸¹ In a roll-up, the DIP lender's pre-petition loan is incorporated into the new DIP financing. The effect is to assure administrative expense priority for any payments due.

⁸² See *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994) (invalidating a stock purchase guarantee in the hostile tender offer context). For an extensive analysis of the appropriate treatment of lockups, both in and out of bankruptcy, see David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243 (2000).

IV. FINE-TUNING THE SECOND GOVERNANCE LEVER: EXECUTIVE PAY

Of the two new governance levers, the second, performance-based executive pay packages, has provoked most of the sound and fury. When Polaroid proposed a retention bonus package for forty-five executives after it filed for bankruptcy, the proposal drew such a hostile response that the debtor was forced to shelve it.⁸³ This outrage, which also has surfaced in recent cases, says more about perceptions than economic incentives. Indeed, in terms of incentives alone, retention bonuses are less troubling than the leverage wielded by post-petition financiers, but the perception issue matters and we will need to account for it.

To make sense of the executive pay issues, we also need to consider the cash flowing into executive coffers before the case is actually filed. Companies that are in financial distress often pay retention bonuses before they ever file for bankruptcy. The justification for the bonuses is quite similar to that of performance-based, post-petition compensation, and so too is the outrage stemming from it. In recent cases, courts have been asked to set aside these bonuses on fraudulent conveyance grounds.

I soon will take up each of the issues—pre-bankruptcy bonuses and performance-based bankruptcy pay—in turn. But first, let me say a bit more about the fault-line running through these managerial pay questions—the tension between incentives and perceived fairness. The case for bonuses and performance-based pay is quite simple. In order to restructure a troubled company, the company must persuade its good managers to stay and give them performance-based incentives to achieve a prompt, efficient reorganization. These, after all, are the executives who know the business best. The case against these bonuses begins with the question of why we should be paying lucrative bonuses to the very executives who managed to steer the company into bankruptcy. In part, this reflects the longstanding debate as to

⁸³ See *Polaroid Withdraws \$5 Million Bonus Plan to Retain Executives*, WALL ST. J., Jan. 14, 2002, at B5 (“[T]he plan infuriated employees and retirees . . . the other bonuses—including the remainder of the \$5 million—would now be shelved while the company tries to come up with another arrangement.”). Nor is the sound and fury limited to executives who were running the company when it filed for bankruptcy. WorldCom’s proposed pay package for Michael Capellas, whom it brought over from Hewlett Packard to take the reins in the middle of the Chapter 11 case, drew sharp criticism from a district court judge who is involved in the case. See Rebecca Blumenstein & Lingling Wei, *WorldCom CEO’s Pay is Criticized*, WALL ST. J., Dec. 11, 2002, at B5 (indicating that Judge Jed S. Rakoff expressed serious concerns about WorldCom management’s commitment to needed reforms).

whether it is better to keep the existing managers in place because they know the business best or to kick the bums out because they ran the company into bankruptcy.⁸⁴ But there is a more visceral fairness concern as well. Watching executives take their lucrative bankruptcy bonuses is deeply disturbing to many—especially other employees, many of whom have lost their jobs, pensions, or both. “It is hard to imagine,” a WorldCom employee wrote in opposition to WorldCom’s bonus plan, “that . . . the efforts of [329 *key* employees] are 1600 times more valuable than all other personnel at the Company.”⁸⁵ While the plan might “maintain [the] morale” of the favored employees, it “will in no way send a positive message to anyone” else.⁸⁶ “Many employees are necessary to implement the reorganization plan,” she reminded the court, “not just the key employees.”⁸⁷ Finally, it is not always obvious that retention bonuses are truly necessary to persuade managers, many of whom may not have other job prospects, to stick around.

Let us start by taking a closer look at the use of retention bonuses on the eve of bankruptcy.⁸⁸ Kmart is perhaps the best recent

⁸⁴ In most other countries, managers are blamed for and immediately displaced when a company files or ends up in bankruptcy or insolvency cases. See, e.g., Armour et al., *supra* note 75, at 1729, 1745 (describing manager displacement in Germany, Japan and England).

⁸⁵ Letter from Julie A. Harazduk, WorldCom, Inc. employee, to Arthur J. Gonzalez, U.S. Bankruptcy Judge 1 (Oct. 24, 2002) (on file with author) (objecting to the Debtors’ Motion to establish a key employee retention plan in *In re* WorldCom, Inc., 296 B.R. 115 (Bankr. S.D.N.Y. 2003)).

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ A somewhat related compensation issue is the sale of stock by executives shortly before bankruptcy. In the simplest case, the executive sells stock that she previously purchased (generally by exercising stock options) or was given by the company. Gary Winnick, the former CEO of Global Crossing, sold a whopping \$500 million worth of stock in the two years before the company filed for bankruptcy. See Andrew Hill, *Barons of Bankruptcy Part III: Let the Good Pay Roll—for Good Performance*, FIN. TIMES, Aug. 2, 2002, at 10 (showing how executives, such as Winnick, cushioned themselves against their companies’ collapse but angered investors in the process). For Enron’s Ken Lay, the harvest was roughly \$220 million. See *Corporate America’s Woes, Continued*, ECONOMIST, Nov. 30, 2002, at 60 (explaining how such rewards produced a backlash among the public that led to reforms).

Pre-bankruptcy stock sales are much harder to defend in incentive terms than the other forms of compensation we will consider. It is not obvious that these sales are essential to retaining top managers and encouraging them to maximize shareholder value. But see Henry G. Manne, *Options? Nah. Try Insider Trading*, WALL ST. J., Aug. 2, 2002, at A8 (defending insider trading generally on compensation grounds and as a mechanism for providing valuable information to the market). Executive stock sales look suspiciously like preferential transfers—that is, transfers that favor one claimant

illustration. Less than a month before bankruptcy, Kmart doled out \$30 million in "retention loans" to its then-CEO, Charles Conaway, and several other top executives.⁸⁹ Retention bonuses can be justified as the only, or at least, a necessary, way to persuade key managers to stay.⁹⁰ However, this doesn't mean that retention bonuses simply should be permitted with no second thoughts. Pre-bankruptcy retention bonuses raise both efficiency and fairness concerns. Whether one emphasizes efficiency or fairness, the chief concern is the agency cost of managers focusing on their own interests rather than what is best for the company. The company's directors are in effect paying their own kind when they pay retention bonuses to top managers, and

over others when there are not enough assets to go around, and which have long been prohibited under American bankruptcy law. See 11 U.S.C. § 547 (2000) (authorizing trustee to retrieve transfers by the debtor within ninety days of bankruptcy, with a one year reachback if the transferee is an insider). To be sure, there are as many differences as similarities. Stock sales, for instance, don't deplete the company's assets to the same extent as preferential transfers. But stock sales leave the executives better off than ordinary creditors and employees, as would a true preference.

Existing bankruptcy law does little to address the problem of pre-bankruptcy stock sales. Stock sales cannot be reversed as preferences because they do not involve a payment by the company on a preexisting debt, and the sales do not qualify as fraudulent conveyances if the executive is selling stock (or converting options) she already owns. Under Rule 10b-5 of the Securities and Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2003), an executive could be forced to disgorge her profits on insider trading grounds if she had "material" nonpublic information when she sold, but this standard is quite difficult to prove unless there is an obvious information event, such as a forthcoming quarterly statement that the executive knows will have surprising new negative information.

The obvious solution is to simply amend the Bankruptcy Code to apply the same rules to stock sales that are applied to preferences. Executives should be forced to disgorge the proceeds of any stock sales they make within eighteen months of bankruptcy. For a similar conclusion and proposals for corporate governance reforms to address Enron and subsequent scandals, see Henry M. Paulson, Chairman and CEO The Goldman Sachs Group, Restoring Investor Confidence: An Agenda for Change, Speech to National Press Club, Washington, D.C. (June 5, 2002) available at <http://www.cglv.hbs.edu/pdf/ViewpointsPaulsonRestoring.pdf>. Some might worry that the disgorgement rule would give executives an incentive to postpone filing for bankruptcy in order to protect their stock sales. But it seems unlikely that the executives could postpone the inevitable long enough for this to be an effective strategy. Overall, then, disgorgement would provide obvious fairness benefits without seriously interfering with efficiency.

⁸⁹ Amy Merrick, *Kmart Officers Got Big Loans Before it Filed for Chapter 11*, WALL ST. J., Apr. 17, 2002, at B1. In theory, the executives were required to repay the loans, but, to the extent there was no expectation of repayment or the terms were more lenient than a market loan, they functioned like bonuses.

⁹⁰ Observers noted, for instance, that "[f]or years, Kmart had trouble making its merchandising systems work well and desperately needed to keep senior executives who oversaw those systems." *Id.* According to one expert, a "wholesale exodus would have meant 'they'd never get any merchandise out of the stores.'" *Id.*

one can't help suspecting that some will use retention bonuses as one last opportunity to ensure themselves a big payday.⁹¹

As it turns out, existing law already provides a mechanism for challenging pre-bankruptcy pay packages that look more like handouts than efforts to retain key executives. Fraudulent conveyance law authorizes the bankruptcy court to reverse a transfer made by an insolvent debtor if the debtor did not receive "reasonably equivalent" value in exchange.⁹² If I sell my house to my sister for \$1 before filing for bankruptcy, the transaction will be voided as a fraudulent conveyance. Although the facts are more subtle, one can make the same kind of argument about excessively generous pre-bankruptcy retention bonuses. Fraudulent conveyance scrutiny has an unavoidably impressionistic quality. Given the benefits of a well-designed retention bonus plan, this ad hoc approach is preferable to per se prohibition, but it also forces us to consider how a judge can determine whether she is looking at a well-structured plan or a disguised handout. One factor that courts should consider is whether the plan gives the executive a direct incentive to stay. A plan that conditions some or all of its benefits on the executive continuing in her post is more defensible than an immediate cash payment, as is a plan that includes performance-based incentives.⁹³ The court should also consider the magnitude of the bonus in comparison to previous bonuses and the executive's overall pay, as well as compensation levels in other, comparable companies.⁹⁴

⁹¹ For an argument that executive compensation arrangements outside of bankruptcy are more likely to reflect managerial power than optimal contracting, see Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

⁹² 11 U.S.C. § 548(a)(1)(B) (2000). The bankruptcy trustee can also use state fraudulent conveyance provisions such as those based on the Uniform Fraudulent Transfer Act ("UFTA"). UNIF. FRAUDULENT TRANSFER ACT §§ 4-5, 7A U.L.A. 266, 301 (1999) The trustee's power to do this comes from 11 U.S.C. § 544(b) (2000), which authorizes the trustee to invoke any non-bankruptcy law that one of the debtor's unsecured creditors could have invoked outside of bankruptcy. There is relatively little substantive difference between § 548 and the UFTA. The principal distinction is that the UFTA provides a longer statute of limitations.

⁹³ Kmart's "retention loans" introduce another twist on this theme. See Merrick, *supra* note 89, at B1 (discussing the loans top executives received just before Kmart filed for bankruptcy). Both the loan itself (if it appears that Kmart had no intention of requiring repayment) and the company's subsequent decision to forgive the loan can be challenged on fraudulent conveyance grounds. The case for disgorgement is strongest if, as with some of the Kmart loans, the loan is forgiven without any obligation for the employee to remain at the company.

⁹⁴ Outside of bankruptcy, compensation arrangements can also be challenged on fiduciary duty grounds. Delaware courts have traditionally shown a great deal of

Turn now to retention bonuses that are put in place after the company files for bankruptcy. Post-petition pay packages raise the same kinds of concerns as pre-bankruptcy bonuses, but with some very important differences. The key distinction is that the directors cannot unilaterally implement a bonus program once the company has filed for bankruptcy; the program must be presented to the bankruptcy court for approval. This means that creditors have the right to file formal objections; and, in practice, creditors weigh in long before the formal hearing. As a result, with post-petition pay packages, there is much less reason to worry that managers are helping themselves at the expense of the business than there is with pre-bankruptcy compensation plans.⁹⁵

The one concern that does loom large in the bankruptcy context is the perception of fairness. Particularly troubling to many is the possibility that managers could make even more money in bankruptcy than they did while the company was healthy. One prominent bankruptcy lawyer put it this way: "In an enterprise [PSINet, a networking company] where catastrophic amounts of money were lost, the notion that people should have to be compensated over and above what they were already getting is offensive."⁹⁶

What does this mean for judicial oversight of bankruptcy bonus plans? The short answer is that courts should not simply rubber stamp any proposed plan, but should exercise a stronger presumption of approval than they do with pre-bankruptcy bonus packages. The presumption should be especially strong if most or all of the company's creditors support the plan. Of course this does not mean that the current post-petition pay arrangements are optimal; rather, they are likely to be superior to straight cash compensation.

deference to compensation arrangements that are approved by a disinterested committee of directors. See, e.g., *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (quoting *Beard v. Elster*, 160 A.2d 731, 738 (Del. 1960), for the proposition that decisions reached by a disinterested board of directors should be given the utmost deference by the courts). But Delaware's judges have hinted that they plan to scrutinize these arrangements more closely in the future, and recent cases are consistent with this warning. See, e.g., *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003). This suggests that fiduciary duty is an alternative line of attack that could be invoked in bankruptcy.

⁹⁵ Stated differently, the creditors (who are the company's residual owners once it files for bankruptcy) exercise much more oversight once the company files than shareholders (or creditors) do with pre-bankruptcy bonus plans.

⁹⁶ Davis, *supra* note 31, at C2 (quoting Chaim Fortgang, a New York attorney then with Wachtell, Lipton, Rosen, & Katz, who represents creditors exclusively).

Let me conclude by taking a closer look at the existing arrangements and possible alternatives to them. The first generation of pay-for-performance contracts—the contracts we are seeing now—have tended to tie managers' performance bonuses to the speed of the case. Although speed is likely to correlate fairly closely with the goal of maximizing the value of the debtor's assets, one certainly can imagine other approaches. Is there a different measure that would more closely link managers' effectiveness to their bankruptcy pay? Two possible alternatives come to mind. The first, and most precise, measure would be to base the managers' pay on the overall value of the debtor's assets at the conclusion of the Chapter 11 case. Tying the managers' pay to the debtor's value would give them a strong incentive to take whatever steps were necessary to maximize value, whether this meant a quick reorganization case or a longer, more thorough process. This strategy works nicely if the company is being liquidated. In reorganization, by contrast, assessing the overall value of the debtor's assets is more difficult, but in at least some cases it is a plausible compensation strategy.⁹⁷

The second alternative would be to promise managers a portion of the stock of the reorganized entity. Outside of bankruptcy, stock-based measures have been criticized as poorly correlated with the executives' performance, given that stock price is affected by a variety of factors over which the executives have no control.⁹⁸ External factors (changes in interest rates or energy prices, for instance) also would influence the value of a reorganized company's stock. But lest we give up on this approach too quickly, I should hasten to add that the managers' efforts have a surprisingly direct effect on the value of the company's stock when it emerges from bankruptcy. The value of the company's post-bankruptcy stock will depend not only on the value of its assets, but also on how much debt the company is able to shed in bankruptcy. Managers play a direct role in both of these areas, and both are important bankruptcy objectives. This suggests that stock-based compensation may be a promising alternative to bonuses based on speed.

⁹⁷ For a recent illustration describing the asset value-based pay in the Adelphia case, see Gretchen Morgenson, *Bankruptcy: A New Route to Riches*, N.Y. TIMES, Jan. 8, 2003, at C1.

⁹⁸ See, e.g., Bebchuk et al., *supra* note 91, at 796-802 (explaining that commonly used stock-based option plans rarely attempt to screen out price changes that have no connection to the executives' performance).

So why haven't managers been offered post-reorganization stock more frequently? There may be some question as to whether the court can set aside "when-issued" stock,⁹⁹ but this doesn't explain why stock-based pay packages are rarely proposed. The possibility that the company may be liquidated rather than reorganized is similarly incomplete. A substantial majority of the largest corporate debtors do in fact reorganize, and the compensation plan could be adjusted to provide for cash compensation in the event of liquidation. The most likely reasons that stock-based compensation is seldom used are that managers like the greater certainty of cash-based performance pay, creditors much prefer that executive pay be linked to speed, and both would, therefore, resist a stock-based approach. The best normative defense of this aversion to stock-based pay is that it could have a troubling effect on managers' incentives in at least a few cases. Managers might threaten to destroy value, or actually destroy value, in order to coerce creditors to accept a draconian "haircut," for instance.¹⁰⁰ However, there is also a less benign explanation as to why creditors haven't clamored for stock-based pay: creditors would much rather have managers focus on speed, since this diminishes the managers' incentives to play hardball with respect to the haircut creditors are expected to take.

The upshot is that the emergence of performance-based pay in bankruptcy should be seen as a welcome development, and courts should continue to approve compensation packages that have substantial creditor support. But there is room for continued experimentation. The most intriguing possibility is the one we have just discussed; that is, promising to give a debtor's managers a slice of the reorganized company's stock.

V. CONCLUSION: CONTRACTING AFTER THE FALL

Bankruptcy isn't exactly a place one expects to see the Coase theorem in action. Bankruptcy is full of intricate regulation and judicial intervention. Yet, to a remarkable extent, creditors have

⁹⁹ Nothing in the Bankruptcy Code explicitly prohibits the use of when-issued stock as compensation, but some bankruptcy lawyers worry that this strategy would interfere with the reorganization process and might therefore be struck down as a "sub rosa" reorganization plan. Interview with Bill Schorling, *supra* note 47.

¹⁰⁰ The notion here is that managers can enhance the value of their when-issued stock by increasing the value of the firm, sharply reducing its debt, or both. The concern is that managers could credibly threaten to destroy value if this loss in value were more than offset by a dramatic scaling down of creditors' claims.

responded to the complaints of the past two decades in precisely the way Coase might predict. Stung in the 1980s by managers' tendency to drag out Chapter 11 cases, creditors have used post-petition lending agreements and managerial compensation contracts to reshape corporate governance in Chapter 11. Cases now move faster, and managers spend much more time overseeing merger and acquisition activity than caballing in smoky backrooms.¹⁰¹

Corrections, of course, never lead us back to a mythological Archimedean point. Adjustments bring their own problems and their own characteristic flaws. Much of our discussion has focused on the dangers of the two new governance levers. With DIP financing agreements, we saw that DIP financiers may use the interim financing agreement to improve the status of their pre-bankruptcy loans, and the lenders' priority could give them too great a bias toward liquidation on the margin. Rather than making structural changes to counteract this bias, the best solution is simply for courts to restrict the provisions that they will permit in a DIP financing agreement, particularly when the debtor obtains DIP financing from an existing lender. With managerial compensation, courts should sharply distinguish compensation agreements that came before bankruptcy from those that are proposed during the bankruptcy case. Pre-bankruptcy bonuses are far more likely to reflect managerial self-dealing and should be scrutinized on fraudulent conveyance grounds. Post-petition compensation, on the other hand, is subject to significant creditor oversight. Creditor support is a good indicator that the program will have a beneficial effect on Chapter 11 governance and should be approved.

Ex post contracts are a second-best solution to the risk that managers will destroy value in Chapter 11 by pursuing their own private interests, rather than maximizing overall firm or social value. A bankruptcy contract that addressed these issues in advance—for instance, by giving managers an incentive to pursue liquidation rather than reorganization if this were efficient—might be preferable in theory.¹⁰²

¹⁰¹ Creditors' responses to concerns about Chapter 11 parallels, in intriguing respects, the increased use of incentive-based compensation outside of bankruptcy after Delaware upheld the use of poison pills. Incentive-based compensation seems to have diminished managers' hostility to takeover bids. See Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 897 (2002) ("There is substantial evidence that [incentive-based compensation packages] have neutralized to a substantial extent managerial opposition to unsolicited bids.").

¹⁰² See Barry E. Adler, *A Theory of Bankruptcy Insolvency*, 72 N.Y.U. L. REV. 343, 367-75 (1997) (suggesting that, if given the opportunity, firms might design their capital

And I wholeheartedly agree with the commentators who have suggested that corporate debtors should be permitted to devise their own bankruptcy rules and to opt out of bankruptcy, if they so choose. But ex ante contracting has its own downsides,¹⁰³ and the most important comparison for present purposes is the comparison between current bankruptcy practice and Chapter 11 in the Eastern Airlines era, circa 1990.

In the past decade, many commentators have dismissed Chapter 11 as hopelessly flawed, and others have suggested that the world has passed it by. The new bankruptcy governance shows that the bankruptcy framework has more life than anyone would have predicted. Companies look different than they did in the old railroad receivership days, but the parties have continued to adapt the same general framework that was first developed well over a century ago. The two new governance levers are the latest chapter in this story, and they are transforming Chapter 11 from a takeover defense to what, at the moment, is our most vibrant market for corporate control.

structure so that liquidation would always be the appropriate resolution in the event of default); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1839 (1998) ("[W]hile a bankruptcy system is needed, the question of *which* system parties should use in particular cases should be for the parties to decide." (emphasis added)).

¹⁰³ The most obvious difficulties with tailored, ex ante bankruptcy contracts are issues of implementation, such as the question of how to effectively alter the contract when the company's fortunes or economic conditions change.

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