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THE NATURE AND EFFECT OF CORPORATE VOTING IN CHAPTER 11 REORGANIZATION CASES

*David Arthur Skeel, Jr.**

INTRODUCTION

BANKRUPTCY theory became something of a cottage industry in the 1980s. Even before the economic slump that marked our transition to the current decade quickly converted hordes of real estate and merger and acquisition attorneys into bankruptcy attorneys, it seemed that every legal scholar with interests remotely related to bankruptcy had something to say about the relatively recently enacted Bankruptcy Reform Act of 1978.¹ Almost without exception, that commentary focuses upon the role of bargaining in a chapter 11 reorganization. Although bankruptcy scholars disagree as to the appropriate role of bankruptcy bargaining,² they take as a given that

* Assistant Professor of Law, Temple University. I am grateful to Alice Abreu, George Cohen, Saul Levmore, Laura Little, Lynn LoPucki, Ed Rock, Bob Scott, and Bill Woodward for helpful comments on earlier drafts. Financial support for this research was provided by the Temple University School of Law.

¹ Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)). My principal concern throughout the Article is with the reorganization provisions set forth in chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-1174 (1988), and in particular with corporate reorganizations involving large, publicly held firms. Hereinafter, Bankruptcy Code provisions will be cited as: "Bankruptcy Code § —."

² Thomas Jackson proposed a "creditors' bargain" model of bankruptcy in the early 1980s, and he and Douglas Baird elaborated upon the model thereafter. Baird and Jackson argue that the purpose of bankruptcy is to provide a collective proceeding for resolving without alteration the parties' diverse entitlements. See, e.g., Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. Legal Stud. 127 (1986); Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (1986); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan. L. Rev. 725 (1984); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L.J. 857 (1982) [hereinafter Jackson, *Creditors' Bargain*]. Other law-and-economics scholars have suggested refinements to various aspects of Baird and Jackson's analysis. See, e.g., Mark J. Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 Va. L. Rev. 219 (1989); Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. Chi. L. Rev. 690 (1986) (proposing a "common disaster" model as a means of explaining the persistent impulse toward redistribution in the Bankruptcy Code).

Another group of commentators rejects the assumptions underlying the creditors' bargain model and argues instead that the model is overly simplistic and gives short shrift to values crucial to the bankruptcy process. See, e.g., James W. Bowers, *Groping and Coping in the*

negotiations among the debtor, its creditors, and its shareholders are the crux of chapter 11.³

Yet bargaining is only a part of the reorganization process; chapter 11 points toward, and culminates in, a vote among the various constituencies of the debtor. A complete understanding of the chapter 11 reorganization process requires an evaluation of its voting provisions as much as of the role of bargaining.

A logical first place to look for help in understanding the chapter 11 voting rules⁴ is to the voting regime that is displaced when a firm files its bankruptcy petition. On first inspection, the two sets of voting rules appear quite different. Outside of bankruptcy, corporate voting is governed by state corporation law. In general, these statutes provide that only common shareholders vote, on a one-vote-per-share basis,⁵ but corporations are free to alter this off-the-rack rule should they so choose.⁶ Although shareholders' principal voting responsibility is to elect the directors who will oversee the activities of the firm, shareholders also vote on the ultimate issues facing a firm. For example, shareholder approval is required for charter amendments and for fundamental corporate changes such as mergers, sales of most or all of a firm's assets, or dissolution.⁷

After a chapter 11 petition has been filed, corporate voting is governed by a federally imposed bankruptcy system. Unlike state corporation law, chapter 11 provides only for a single, all-encompassing

Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure, 88 Mich. L. Rev. 2097 (1990); Donald R. Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy, 91 Colum. L. Rev. 717 (1991); Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775 (1987).

³ See, e.g., Baird, *supra* note 2, at 145; Raymond T. Nimmer & Richard B. Feinberg, Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity, 6 Bankr. Dev. J. 1, 51 (1989).

⁴ Bankruptcy Code §§ 1121-1129; see *infra* Part II.A. for a detailed description of these rules.

⁵ See, e.g., Del. Code Ann. tit. 8, § 212(a) (1983).

⁶ A corporation can provide in its charter for cumulative voting, weighted voting, a staggered board, or almost any other designer voting term. See, e.g., *id.* § 102(b) (giving firms significant leeway in tailoring voting provisions to their needs); *id.* § 214 (certificate of incorporation may provide for cumulative voting); *id.* § 221 (voting rights may be given to bondholders and debenture holders); see also Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 399 (1983) (overview of corporate voting rules and practices).

⁷ Del. Code Ann. tit. 8, § 242 (1983) (charter amendments); *id.* § 251 (mergers); *id.* § 271 (sales of most or all of the firm's assets); *id.* § 275 (dissolution).

vote on whether to approve or reject a reorganization plan. Also unlike state corporation law, which limits the franchise to the firm's shareholders, chapter 11 permits every holder of a claim or interest to cast a ballot on the plan, except those who will be compensated in full or who will receive nothing under a given plan of reorganization.

This Article attempts to demonstrate that, despite striking superficial differences, chapter 11 voting can and should be seen as an extension of the state corporate law voting rules. Part I proposes a two-pronged contractual explanation of shareholders' monopoly of the franchise outside of bankruptcy. In Part II, I apply this explanation to chapter 11's voting provisions. The analysis demonstrates that chapter 11's voting rules are responsive to precisely the same normative concerns that explain shareholder suffrage outside of bankruptcy. I conclude Part II by exploring several positive dimensions of the analogy.

In Part III, I apply my analysis to several particularly troublesome chapter 11 voting issues—including sales of most or all of a firm's assets, directorial elections, and the supermajority requirement for plan approval. The analysis suggests that once in bankruptcy, sales of most or all of a firm's assets should be approved by a majority of the firm's unsecured creditors, rather than by a court. The analysis also suggests that unsecured creditors, rather than shareholders, should be the voters in any directorial election. Finally, Part III argues for replacing chapter 11's current supermajority voting standard with simple majority voting to reduce the threat of a creditor's acquiring a blocking position and using this veto power improperly.

In Part IV, I address a potential objection to vesting additional voting power in unsecured creditors. The thrust of this argument is that, because the unsecured creditors of publicly held debtors often are widely dispersed, collective action problems might prevent them from exercising the franchise effectively and thus make it pointless to alter the current voting rules. Drawing on the work of several social scientists,⁸ I conduct an in-depth analysis of the parties' collective action dilemma in chapter 11, and of the Bankruptcy Code's (imperfect) solution—chapter 11 committees. The inquiry suggests that

⁸ See Russell Hardin, *Collective Action* (1982); Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (2d ed. 1971); William J. Baumol, *Welfare Economics and the Theory of the State* (2d ed. 1965).

unsecured creditors would still be, as originally argued, better voters than judges or shareholders.

I. IN THE BEGINNING: SHAREHOLDER VOTING OUTSIDE OF BANKRUPTCY

Nearly a decade ago, Kenneth Scott noted that in the "emerging perspective, the 'entity' of the public corporation is merely a legal device for tying together an interconnecting web of contracts among all the suppliers of factors of production in ways that lower the transaction costs of organizing production."⁹ In subsequent years, this nexus-of-contracts perspective has provided important new insights into the nature of publicly held firms.¹⁰ In this Part, I draw from this and related literature in developing a two-pronged contractual justification for the observation that, outside of bankruptcy, in the vast majority of publicly held corporations the franchise is exercised by a single class of common shareholders under a one-share, one-vote allocation.¹¹ My two-pronged analysis brings together the somewhat divergent insights of, among others, Frank Easterbrook, Daniel Fis-

⁹ Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 *Stan. L. Rev.* 927, 930 (1983). The origins of this perspective date to R.H. Coase, *The Nature of the Firm*, 4 *Economica* 386 (1937).

¹⁰ E.g., Symposium, *Contractual Freedom in Corporate Law*, 89 *Colum. L. Rev.* 1395 (1989) (debating whether corporate law is enabling, as the nexus-of-contracts advocates argue, or mandatory).

¹¹ As noted, corporations enjoy significant freedom to alter this off-the-rack rule. Close corporations in particular often adopt one or more special voting provisions. In the vast majority of publicly held corporations, however, the franchise is exercised by a single class of common stockholders. See, e.g., Easterbrook & Fischel, *supra* note 6, at 399-400.

The recent spate of dual class recapitalizations casts an interesting light on this observation. In the face of the takeover wave of the 1980s, the managers of numerous publicly held corporations sought to insulate themselves by effecting, through exchange offers, a division of their firm's stock into two classes: one class typically would have greater voting rights and be controlled by management; the other class typically would have lesser voting rights but offer larger dividends. Several commentators decried this development and called on the Securities and Exchange Commission ("SEC") to restrict such dual class recapitalizations. See, e.g., Jeffrey N. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 *Cal. L. Rev.* 1 (1988) (arguing that firms delisted from the New York Stock Exchange for deviating from the one-share, one-vote norm should be prohibited from listing on another exchange). The SEC's response, Rule 19c-4, 17 C.F.R. § 240.19c-4 (1990), effectively banned dual class recapitalizations but subsequently was invalidated. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990). Dual class recapitalizations are exceptional and thus do not undermine the suggestion that most firms limit voting to a single class of shares in that they occur predominantly in firms with an unusually high percentage of family ownership. See Gordon, *supra*, at 44-46; Peter N. Flocos, Comment, *Toward a*

chel,¹² and Oliver Williamson.¹³ In this Part, I also address shareholders' collective action problems and the issue of whether shareholders care about their voting rights. The analysis of this Part will then be used, in Part II, to examine the voting rules imposed by chapter 11.

A. Residual Ownership and the Problem of Agency Costs

The first prong of the contractual analysis of corporate voting is the link between agency costs and the choice of shareholders as keepers of the franchise.¹⁴ In corporations, agency costs stem from the divergence of interests between shareholders, who theoretically own the corporation, and the managers, who run the corporation.¹⁵ More generally, agency costs exist whenever a decisionmaker will not reap the full benefit or bear the full cost of her decisions, and thus lacks the appropriate incentives. Because shareholders have no stake in a corporation's assets until all other claimants have been paid in full, shareholders are the firm's residual owners so long as the firm remains solvent. The significance of this residual ownership status from an agency cost perspective is that it invests shareholders with decision-

Liability Rule Approach to the "One Share, One Vote" Controversy: An Epitaph for the SEC's Rule 19c-4?, 138 U. Pa. L. Rev. 1761 (1990).

¹² Easterbrook & Fischel, *supra* note 6; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989).

¹³ See Oliver E. Williamson, *Corporate Governance*, 93 Yale L.J. 1197 (1984) [hereinafter Williamson, *Corporate Governance*]; Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 Am. Econ. Rev. 519 (1983); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & Econ. 233 (1979) [hereinafter Williamson, *Transaction-Cost Economics*].

¹⁴ Identifying agency costs is the central insight of the nexus-of-contracts theorists. Seminal contributions to this literature include Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976); Oliver E. Williamson, *Managerial Discretion and Business Behavior*, 53 Am. Econ. Rev. 1032 (1963). Easterbrook and Fischel first applied the insights of agency cost analysis to corporate voting. Easterbrook & Fischel, *supra* note 6. In the discussion that follows I draw liberally from their analysis, which has become the standard neoclassical account of corporate voting.

¹⁵ Shareholders' delegation of authority to the firm's day-to-day managers is indirect. Shareholders elect directors, see, e.g., Del. Code Ann. tit. 8, § 211 (1983), who then hire the officers who oversee the ordinary operations of the firm, see, e.g., *id.* § 142.

making incentives superior to those of any other constituency of the firm.¹⁶

Consider the following illustration comparing shareholders' and creditors' incentives: assume that a corporation's assets currently are worth \$200, that the corporation owes a bank \$125, that a bondholder, whose claim is subordinated to that of the bank, is owed \$50, and that the sole shareholder has a claim to the \$25 residual; assume further that the corporation is presented with an investment opportunity, which, if pursued, carries a 50% chance the corporation will be worth \$300 in one year but also a 50% chance the corporation will be worth only \$150. Clearly, the wealth-maximizing response would be to pursue the opportunity because the present value of the opportunity is \$225 (\$25 more than the current value of the firm).¹⁷ It is far from obvious, however, that either the bank or the bondholder would encourage the corporation to undertake the venture. The bank is likely to be indifferent to the opportunity because its claim will be paid regardless and it gets no benefit from any upside potential. The bondholder, on the other hand, will actively oppose the venture because the opportunity creates a 50% chance that she will lose one-half of her claim whereas she currently expects payment in full. Only the shareholder, whose expected residual interest will increase from \$25 to \$50, can be expected to view the venture with enthusiasm.¹⁸

Shareholders' decisionmaking incentives also are better than those of the managers of the firm, who typically own only a small percentage of the firm's stock and thus do not feel the full impact of their

¹⁶ See, e.g., Robert C. Clark, *Corporate Law* § 9.5, at 389-90 (1986); Easterbrook & Fischel, *supra* note 6, at 403-06.

¹⁷ The value of the opportunity equals the sum of each possible value discounted by the probability of its occurrence. Thus, in the example, the value equals $(\$300 \times .50) + (\$150 \times .50) = \$150 + \$75 = \$225$. For the sake of simplicity, I have assumed risk neutrality and have ignored the time value of money.

¹⁸ To be sure, shareholders' incentives are not perfect. Shareholders may, especially if the firm is in a precarious financial condition, encourage the firm to pursue unduly risky ventures because much of the risk of such ventures would be borne by higher priority creditors, such as the bondholders. Risk-taking of this sort effects a redistribution from creditors to shareholders, for shareholders enjoy much of the upside potential but little of the downside risk. See Easterbrook & Fischel, *supra* note 6, at 404; Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 *Colum. L. Rev.* 527, 549-53 (1983); *infra* Part III.A. (detailed discussion of this observation and its implications for corporate voting in the bankruptcy context). Moreover, even appropriate risk-taking by the shareholders may have third-party effects, as is illustrated by the bondholder's potential exposure in the hypothetical.

decisionmaking. In recent years, some firms have attempted to realign their managers' incentives through a variety of stock option plans and by coordinating even managers' base compensation with the performance of the firm's stock.¹⁹ The recent controversy concerning the perceived excesses of management compensation provides telling evidence that these measures have not been fully effective.²⁰

Agency costs also explain in part the tendency to limit voting to one vote per share. If shareholders have a single vote for each share of stock, their voting power mirrors their economic incentives. By contrast, the creation of disproportionate voting power introduces additional agency costs. Shareholders with more than one vote per share of stock will not receive gains or losses commensurate with the influence they wield and therefore cannot be expected to make optimal decisions on behalf of the corporation.²¹ In sum, because shareholders have decisionmaking incentives superior to managers and all other constituencies, they appropriately hold a monopoly of the franchise outside of the bankruptcy context.

¹⁹ See generally Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 Del. J. Corp. L. 540, 559-62 (1984) (arguing that compensation packages such as stock option plans improve managers' decisionmaking incentives); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. Rev. 913, 918-19 (1982) (same).

²⁰ See, e.g., Karen W. Arenson, *The Boss: Underworked and Overpaid?*, N.Y. Times, Nov. 17, 1991, § 7 (Book Reviews), at 11 (reviewing Graef S. Crystal, *In Search of Excess: The Overcompensation of American Executives* (1991)).

²¹ The problem of disproportionate incentives may also help explain courts' longstanding antipathy toward attempts to buy votes without also buying the shares to which the votes attach. See *Macht v. Merchants Mortgage & Credit Co.*, 194 A. 19 (Del. Ch. 1937); Easterbrook & Fischel, *supra* note 6, at 410-11. But see *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982) (purchase of voting rights without transfer of stock is not necessarily illegal); *Wincorp Realty Invs. v. Goodtab, Inc.*, No. 7314 (Del. Ch. Oct. 13, 1983) (reported at 8 Del. J. Corp. L. 636 (1983)) (agreement between shareholders involving sale of voting rights is not illegal per se); Thomas J. Andre, Jr., *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. Cal. L. Rev. 533 (1990) (arguing that vote buying provides both bidders and stockholders with an additional financial incentive); Robert C. Clark, *Vote Buying and Corporate Law*, 29 Case W. Res. L. Rev. 776 (1979) (arguing in favor of permitting "equity-centered" vote buying); Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 Colum. L. Rev. 1427 (1964) (concluding that vote selling is invaluable to the functioning of the United States corporate system). See *infra* note 223 for a more detailed discussion of vote buying.

B. Voting Rights as a Generalized Contractual Safeguard

The second prong of the contractual analysis focuses on the nature of the contractual relationship between shareholders and firms. Many of the contracts into which firms enter are long-term relationships with suppliers, lenders, and employees. If these ongoing contracts require investment in contract-specific assets or skills, they may give rise to bilateral monopolies—that is, each of the parties will have a strong incentive to preserve the relationship, rather than to reenter the marketplace at the cost of losing any transaction-specific asset and being forced to redevelop it in a subsequent contract.²² The danger in any bilateral monopoly situation is that one party will later behave opportunistically²³ in an effort to appropriate the monopoly gain.²⁴

A similar long-term contractual relationship exists between shareholders and firms, even though shares of stock in publicly held corporations frequently change hands.²⁵ Unlike other constituencies, however, shareholders cannot with relative ease safeguard against opportunism by the firm's managers. Employees who have developed (or will develop) firm-specific skills, for example, can contract for severance pay or unionize;²⁶ this minimizes the danger that the firm will terminate them prematurely.²⁷ Similarly, suppliers who make firm-specific investments can require progress payments or a price pre-

²² Williamson, *Corporate Governance*, supra note 13, at 1202; Williamson, *Transaction-Cost Economics*, supra note 13; see also Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901 (1986) (analyzing the specialized relationship that develops, and is encouraged by article 9 of the Uniform Commercial Code ("UCC"), between a debtor and its principal lender).

²³ The terms "opportunism" and "strategic behavior" as used in the text denote inappropriate behavior, that is, behavior that exceeds the bounds of ordinary arms-length bargaining. Williamson defines opportunism as "self-interest seeking with guile." Oliver E. Williamson, *The Economic Institutions of Capitalism* 47 (1985).

²⁴ Williamson, *Corporate Governance*, supra note 13, at 1202-05. This problem arises only if transaction-specific assets (such as customized equipment or job-specific employment skills) are at stake. Otherwise, both parties can transfer their assets to another contract at low cost in the event the relationship breaks down. See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 Va. L. Rev. 1089, 1100-01 (1981).

²⁵ Williamson, *Corporate Governance*, supra note 13, at 1210.

²⁶ See Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 U. Pa. L. Rev. 1349 (1988).

²⁷ The firm itself is similarly protected because employees who quit prematurely may forfeit unvested pension benefits and accrued vacation days. Williamson, *Corporate Governance*, supra note 13, at 1208.

mium, and bondholders are protected both by a plethora of bond covenants and by the right to renegotiate their relationship with the firm (or to walk away) at the end of the bond term. Lenders protect themselves not only with provisions defining breach of a covenant or warranty as a default, but also with broadly worded insecurity clauses that authorize the lender to accelerate the debtor's loan if the lender loses faith in the debtor's ability to service the debt.²⁸

Because the relationship between shareholders and the firm is not subject to periodic renewal, shareholders do not have the same ability to renegotiate.²⁹ In addition, because their investment in a firm cannot be traced to any particular assets, shareholders also are unable to create asset-based safeguards.³⁰ The shareholders' vulnerability is not absolute. They do have access to a small repertoire of specific safeguards, such as charter provisions and information requirements, but these safeguards provide only limited protection. Unfortunately, it is all too easy for management to amend the corporate charter³¹ or to limit the usefulness of the information that shareholders receive.

The threat of opportunism in this context provides further support for the choice of shareholders as voters.³² Because the nature of their relationship with the firm precludes the adoption of a specific, localized governance structure to prevent strategic behavior, shareholders rely on their voting rights and, in particular, on their right to choose

²⁸ The UCC imposes significant restraints on the breadth of creditors' insecurity clauses, however. Most importantly, U.C.C. § 1-208 permits a creditor to exercise such a clause only if she "in good faith believes that the prospect of payment or performance is impaired." Courts have occasionally applied this "good faith belief in impairment" requirement in other contexts as well. See, e.g., *Brown v. Avemco Inv. Corp.*, 603 F.2d 1367, 1375-80 (9th Cir. 1979) (applying the requirement to a due-on-lease default clause). These limitations support the view that creditors are not fully protected by contract.

²⁹ Williamson, *Corporate Governance*, supra note 13, at 1210. An individual shareholder can of course sell her shares, but the terms of the rights associated with the shares will not change in the hands of the buyer, who will likewise be unable to negotiate.

³⁰ *Id.*

³¹ The firm's managers cannot amend its charter without shareholder approval, but in most contexts collective action problems will preclude effective opposition by shareholders. See *infra* Part I.C. for a further discussion of shareholders' collective action problems.

³² Although the contractual safeguard analysis developed in this Section complements the agency cost/residual ownership perspective discussed in the previous Section, the two start from somewhat different premises. The contractual safeguard analysis questions an important assumption of the residual ownership version of the agency cost perspective—that the markets in which a corporation contracts are fully competitive—and focuses on parties' efforts to minimize the transaction costs that result from such incomplete competition (as when bilateral monopolies develop).

directors who will monitor the behavior of management on their behalf.³³ This idea also explains the one-share, one-vote rule. If a shareholder had less than one vote per share of stock, the value of the contractual safeguard would be diminished. It is precisely this concern that lies at the heart of the recent controversy over dual class recapitalizations.

John Coffee has recently underscored the intuition that creditors and employees, notwithstanding the apparent effectiveness of their safeguards, also may be exposed to the threat of management opportunism.³⁴ Coffee frames his analysis as a reconsideration of the puzzle of firms' use of free cash flow. Commentators have long viewed with suspicion managers' tendency to retain or reinvest free cash flow even when it seems inefficient to do so. Managerialists and transaction cost economists both have attempted to explain such behavior as "empire building" by managers.³⁵ Coffee suggests that an alternative explanation is equally plausible. Coffee argues that, over and above the firm's explicit contracts with creditors and employees, managers implicitly may have promised to protect these stakeholders' interests by retaining cash flow rather than distributing it to shareholders as dividends. The advent of "bust up" takeovers destabilized the implicit bargains, however. Faced with the threat of a takeover, managers often arranged their own leveraged buyouts, thus diverting the firm's cash flow to its former shareholders and perhaps breaching the managers' unwritten contract with the firm's creditors and employees.³⁶

³³ Williamson, *Corporate Governance*, *supra* note 13, at 1210-11. Therefore, eliminating shareholders' voting rights likely increases the firm's cost of capital. The firm might minimize this effect by giving its shareholders the option of converting their stock into debt.

³⁴ See John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 *Geo. L.J.* 1495 (1990). Coffee's focus is on the existence and limitations of implicit contracting in the corporate context. The explicit bargains struck by creditors and employees also may afford inadequate protection against strategic behavior, as when the firm uses bankruptcy as a means of evading its contractual obligations. See, e.g., Joel Kurtzman, *Business Diary: Those Irsome Gas Contracts*, *N.Y. Times*, Aug. 4, 1991, § 3, at 2 (Columbia Gas System files for chapter 11 relief to force renegotiation of long-term natural gas contracts, which, because of a drop in natural gas prices, required it to pay up to five times the then-current market price).

³⁵ Coffee, *supra* note 34, at 1500. For examples of the managerialist approach, see William J. Baumol, *Business Behavior, Value and Growth* (1959); Merritt B. Fox, *Finance and Industrial Performance in a Dynamic Economy* (1987); Williamson, *supra* note 14.

³⁶ The principal problem with implicit contracting in this context is that managers can defect without compensating the parties injured by their defection. Coffee, *supra* note 34, at 1535. But see Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 *Colum. L.*

Creditor vulnerability to strategic behavior by management does not undermine shareholders' claim to the franchise, because shareholders clearly are still the most exposed of the firm's constituencies and thus have the greatest need for voting rights. Yet Coffee's analysis raises once again a question vigorously debated in the past: should shareholders share their voting rights? That is, should creditors and employees also be entitled to vote and to be represented on the board?³⁷ One problem from the shareholders' point of view with expanding the franchise in this fashion is that even if shareholders' representatives usually controlled board and other voting outcomes, shareholders' contractual safeguards and decisionmaking authority would be undermined by the presence of constituencies with potentially conflicting interests.

Second, multiple-constituency representation would affect adversely the decisionmaking apparatus of the corporation as a whole. The inefficiencies created by the presence of multiple decisionmakers are well documented in the literature. Not only would each constituency tend to divert the attention of the board to its own operating-level complaints, but when the multiple decisionmakers did consider

Rev. (forthcoming April 1992) (questioning Coffee's normative assumption that coalitions are desirable).

³⁷ See, e.g., L.C.B. Gower, J.B. Cronin, A.J. Easson & Lord Wedderburn of Charlton, *Gower's Principles of Modern Company Law* 9-11 (4th ed. 1979); Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. Comp. Corp. L. & Sec. Reg. 155, 170 (1982). The argument in favor of extending the franchise arguably derives from the historical debate over whether directors owe duties to all of the constituencies of a firm. See E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145 (1932). The "other constituency" debate has gained new currency in recent years, largely as a response to the takeover wave of the 1980s. See, e.g., ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 Bus. Law. 2253 (1990) (criticizing states' adoption, as a means of preventing unwanted takeovers, of statutes that permit managers to take other constituencies into account when making decisions on behalf of the firm). Interestingly, employees have shown a much greater interest than either bondholders or other creditors in protecting themselves through representation on the board of directors. Coffee suggests that employees' greater concern with the identity of the firm's managers results from their having a less viable exit option. Coffee, *supra* note 34, at 1521. Employees are also particularly vulnerable to the effect of informational asymmetries vis-à-vis the firm and seek representation in part to ensure ongoing access to relevant information. Williamson, *Corporate Governance*, *supra* note 13, at 1208-09. Employees' inability to diversify may also be a factor.

larger issues, they also would be unlikely to produce a consistent set of management and policy choices.³⁸

Finally, the firm would incur significant informational costs in educating the additional constituencies as to the strategies and operations of the firm. In short, expansion of the franchise would generate costs that appear to outweigh its utility.³⁹ A contractual safeguard analysis therefore supports the view that shareholders should retain their monopoly on voting rights.

C. The Collective Action Dilemma in Corporate Voting

Having established a double-edged normative justification for shareholders' privileged status with respect to voting, it is time to consider how useful shareholders' voting rights prove in practice. As has frequently been noted, significant obstacles hinder effective collective action by the shareholders of a publicly held firm.

The first obstacle is rational apathy. Shareholders, or their agents, must incur significant costs if they wish to cast their vote on any given proposal in an intelligent fashion. These costs include, at the least, the costs of securing relevant information, of developing the capacity to evaluate such information, and of actually evaluating the proposal at hand (or of hiring an agent to perform these tasks).⁴⁰ If the expected payout to a shareholder from informed voting is less than the total of these costs, even a rational shareholder would forgo the benefits of informed voting, because the shareholder will be better off if she simply returns the proxy provided by management and lets management cast her vote.

Free riding discourages collective action even in contexts where the benefits of informed voting outweigh the costs of becoming an informed voter. Widely dispersed shareholders rarely will incur the costs of informing themselves because each knows she will share equally in the benefits of informed voting by her fellow shareholders

³⁸ Kenneth J. Arrow, *Social Choice and Individual Values* (2d ed. 1963); Easterbrook & Fischel, *supra* note 6, at 405; Williamson, *Corporate Governance*, *supra* note 13, at 1206.

³⁹ My conclusion that creditors and employees should not enjoy voting rights does not mean to suggest that it would never be appropriate to address managerial opportunism in other ways. See, e.g., Coffee, *supra* note 34, at 1548 (suggesting that corporate stakeholders should be compensated for the losses suffered as a result of management's breach of implicit contracts in the takeover context).

⁴⁰ See Manne, *supra* note 21, at 1440.

even if she does not bother to vote in an informed fashion herself.⁴¹ The likelihood of free riding thus creates a classic prisoner's dilemma: it is in shareholders' collective best interest for each shareholder to fully inform herself, but the individually rational strategy for most shareholders is not to do so.⁴² Faced with these barriers, shareholders are more likely simply to sell their shares than to incur the costs of becoming an informed voter and of organizing opposition to management proposals.

Given the dampening effect of collective action problems on meaningful shareholder participation in most contexts, one might question whether shareholders care about their voting rights. Focusing on the constituencies who hold competing (and superior) claims to the assets of the firm suggests a partial explanation for the suspicion that, even in the face of these collective action problems, shareholders would not gladly relinquish the franchise. Simply stated, someone must vote, and what shareholders want is for the votes to be held and cast by parties with interests similar to theirs.⁴³ Shareholders may be content to live with the chilling effect of collective action problems on their efforts to organize, no matter how severe, because their retention of the voting right ensures that adverse parties will not possess it.

Another reason shareholders value the franchise is because of its particular importance to the market for corporate control. Takeover bidders typically offer current shareholders a significant premium

⁴¹ Free riding comprises a pair of related problems. The first is the impossibility of exclusion: shareholders who inform themselves, and then organize other shareholders either for or against a given proposal, cannot prevent those who do not bother to inform themselves from sharing in the benefits of their efforts. Second, there is no obvious means of compelling all shareholders to contribute to the costs of voting in an informed fashion. See Gordon, *supra* note 11, at 44 n.142. The proxy contest reimbursement rules are designed to help overcome these problems by taxing the costs of a proxy fight to the firm, but as a practical matter insurgents are not compensated unless their action both is successful and results in a change in control of the firm. See, e.g., *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955); Clark, *supra* note 21, at 782.

⁴² Clark, *supra* note 16, § 9.5, at 391-93. Hardin has demonstrated that the logic of the prisoner's dilemma, which game theorists originally developed in the context of two-person games, applies equally to multiplayer games. Hardin, *supra* note 8, at 27-28; Russell Hardin, *Collective Action as an Agreeable n-Prisoners' Dilemma*, 16 *Behav. Sci.* 472 (1971).

⁴³ I am grateful to Saul Levmore for this insight. The shareholders' concern is both that other constituencies' interests may diverge from their own and also that, if these constituencies do not face equally debilitating collective action problems, they may be able to act successfully upon those interests.

over the market price of their shares,⁴⁴ largely because they want to buy the shareholders' voting rights, which are necessary for a successful assertion of control. The desire to be on the receiving end of such a takeover premium further explains why shareholders may care deeply about the franchise.⁴⁵

Finally, recent trends suggest a somewhat different view of the collective action problem and whether it reduces the large majority of corporate votes to a mere formality. To appreciate these developments, consider first Russell Hardin's analysis of collective action. Borrowing his terminology from Thomas Schelling, Hardin has described the smallest subgroup of a larger group for whom it would be rational to ensure that the larger group provides a collective good⁴⁶ as the smallest efficacious subgroup, or (k).⁴⁷ Hardin demonstrates that as the ratio of the collective-good benefits to costs increases, the size of this subgroup decreases.⁴⁸ For shareholders, the collective good is informed voting.⁴⁹ Because the benefits to a shareholder of informed voting increase with an increase in the extent of her share-

⁴⁴ See Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 *Stan. L. Rev.* 597, 601 (1989); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 *Colum. L. Rev.* 891, 892 (1988). Commentators dispute the source of the premiums. Compare Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161 (1981) (premiums reflect gains from synergy and improved management) with Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 *Yale L.J.* 1235 (1990) (premiums may reflect price pressure rather than efficiency gains).

⁴⁵ Bankruptcy is another specialized context where shareholders' voting rights may prove important. Shareholders may be able to compel a shareholders' meeting in chapter 11 and to employ this ability strategically. See *infra* Part III.B. for a more detailed discussion of shareholders' right to compel a shareholders' meeting; see also Lynn M. LoPucki & William C. Whitford, *Shareholders Unite! There's Leverage in Delaware*, X *ABI Newsletter* 18, 19 (July 1991) (suggesting that shareholders may wish to cause the firm's chapter 11 petition to be filed in Delaware, rather than New York, due to the greater probability in Delaware that they will be permitted to call a shareholders' meeting).

⁴⁶ A collective good is one characterized by impossibility of exclusion; that is, if a group supplies such a good, the members who contributed to its provision cannot prevent members who did not from sharing in the benefits of the good. Hardin, *supra* note 8, at 19.

⁴⁷ *Id.* at 41 (citing Thomas C. Schelling, *Micromotives and Macrobehavior* 213-43 (1978); Thomas C. Schelling, *Hockey Helmets, Concealed Weapons, and Daylight Saving: A Study of Binary Choices with Externalities*, 17 *J. Conflict Resol.* 381 (1973)).

⁴⁸ *Id.* at 40-41. See *infra* Part IV for further discussion of the dynamics of (k), the smallest efficacious subgroup, and its significance for groups' efforts to act collectively.

⁴⁹ Edward Rock's more precise definition of informed voting is "disciplining." Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 *Geo.*

holdings, the smallest efficacious subgroup also decreases in size as the concentration of shareholdings increases. Thus, the likelihood that shareholders will overcome the collective action problem depends, at least in part, on the extent to which shareholdings are concentrated in the hands of relatively few investors.⁵⁰

The dramatic increase in institutional ownership of stock has given rise to just such an increase in concentration and has led many commentators to predict substantial inroads on the collective action problem. These commentators are not prophesying in a vacuum. Institutional shareholders already have begun to take a more active role in corporate governance, as evidenced by the substantial support that many shareholder proposals—especially those relating to takeovers—have received in recent years.⁵¹ Though commentators disagree as to whether institutional investors will be effective champions of shareholders' interests,⁵² there seems to be substantial agreement that institutional shareholder activism is the direction of the future, and thus that the traditional view of shareholders as powerless in the face of the collective action dilemma is no longer fully accurate.

II. AFTER DISASTER: CORPORATE VOTING IN CHAPTER 11 REORGANIZATION CASES

Sections 1121 to 1129 of the Bankruptcy Code provide an elaborate network of voting rules for the purpose of regulating the chapter 11 franchise. Commentators have considered isolated aspects of the voting rules⁵³ and have also addressed various chapter 11 voting issues

L.J. 445, 454 (1991); see also Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 522 (1990) (defining the collective good as "shareholder voice").

⁵⁰ Rock, *supra* note 49, at 459.

⁵¹ *Id.* at 481-84. In fiscal year 1987, 45 shareholder resolutions were approved by more than 20% of the firm's shareholders. Sharon Marcil & Peg O'Hara, Voting by Institutional Investors on Corporate Governance Issues in the 1987 Proxy Season app. 55-58 (1987). By 1990, this number had mushroomed to 160. 7 IRRC Corp. Governance Bull., July-Aug. 1990, at 115-23. In both years the vast majority of resolutions related to takeovers.

⁵² Compare Rock, *supra* note 49 (expressing skepticism as to the efficacy of institutional shareholder activism due to agency costs associated with their money managers) with Black, *supra* note 49 (adopting a more optimistic view).

⁵³ See, e.g., Ethan D. Fogel, Confirmation and the Unimpaired Class of Creditors: Is a "Deemed Acceptance" Deemed an Acceptance?, 58 Am. Bankr. L.J. 151 (1984) (arguing that a "deemed acceptance" should satisfy the one class acceptance requirement for confirmation of a plan under the original version of Bankruptcy Code § 1129(a)(10)).

without reference to these provisions.⁵⁴ What they have not done as yet is consider chapter 11 suffrage as a unified whole. In this Part, I bring the insights developed in Part I to bear in an effort to provide such an analysis. My inquiry shows that, despite their major superficial differences, state corporate law voting rules and the chapter 11 voting framework are largely consistent from a normative perspective. The voting regime is not perfect, however. I consider several problems with the voting rules and propose possible solutions at the end of the Part. To facilitate both the analysis of this Part and its application to specific voting issues in Part III, I defer until Part IV detailed discussion of the parties' collective action problems.

A. An Overview of Corporate Voting in Chapter 11

Chapter 11 provides a voting framework remarkably different from corporate voting outside of bankruptcy. The crucial distinction lies in section 1126(a), which states that any "holder of a claim or interest allowed under [section] 502 of this title . . . may accept or reject a plan."⁵⁵ Simply put, whereas shareholders enjoy a monopoly of the franchise before the corporation files its petition, section 1126(a) establishes universal suffrage as the norm in chapter 11,⁵⁶ at least to the extent the parties are voting on a reorganization plan.

Understanding the voting regime set forth in sections 1121 to 1129 is central to appreciating the significance of this distinction. Section 1123(a) provides, as a starting point, that the proponent of a reorganization plan must organize the claims against and interests in the corporation into classes.⁵⁷ Section 1126 establishes a system of classified voting on the plan.⁵⁸ Under section 1126(c), acceptance by creditors requires the approval of two-thirds in amount and a majority in

⁵⁴ See, e.g., Raymond T. Nimmer & Richard B. Feinberg, Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity, 6 Bankr. Dev. J. 1, 15-20 (1989) (suggesting that sales of substantial assets prior to confirmation may allow the debtor to subvert the participatory, negotiated process of bankruptcy).

⁵⁵ Bankruptcy Code § 1126(a).

⁵⁶ Bankruptcy Code § 1126(f)-(g) carve out limited exceptions to this norm. See *infra* note 63 and accompanying text.

⁵⁷ *Id.* § 1123(a) (requiring a plan proponent to designate classes of claims and interests and to specify any that are not impaired).

⁵⁸ *Id.* § 1126.

number of the claims in each class of creditors.⁵⁹ Acceptance by a class of interests requires that two-thirds in amount of the allowed interests cast their votes in favor of the plan. Thus, the emphasis of section 1126 rests on whether the class as a whole votes for or against the plan.

Obviously, in determining which claims or interests belong in a particular class, the plan proponent has a tremendous incentive to choose her classes in such a way as to "rig" the vote if she can. For example, she might place dissident claimants in a class whose other claimants can be counted upon to support the plan and carry the class. Section 1122(a) imposes significant limitations on this sort of maneuvering, however, by permitting the proponent to "place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class."⁶⁰

After the court approves the contents of the plan, including its classification of claims and interests, and every interested party receives an appropriate disclosure statement,⁶¹ the plan proponent must secure

⁵⁹ *Id.* § 1126(c). The "amount" of each creditor's claim is determined in accordance with § 502 of the Bankruptcy Code. *Id.* § 1126(a). Among other things, § 502(a) requires the bankruptcy court to estimate the amount of a contingent or unliquidated claim, and § 502(b)(5) disallows any claim to the extent it is based on interest that is unmatured as of the commencement of the chapter 11 case. Interestingly, bonds and other debt instruments are allowed in their face amount, even if the debt is trading well below face value at the time of bankruptcy. *In re Lorraine Castle Apartments Bldg. Corp.*, 149 F.2d 55 (7th Cir.), cert. denied, 326 U.S. 728 (1945); Chaim J. Fortgang & Lawrence P. King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. Rev. 1148, 1161 n.57 (1981). On the other hand, the unaccrued portion of original issue discount instruments is disallowed as unmatured interest. *In re Chateaugay Corp.*, 109 B.R. 51, 54-57 (Bankr. S.D.N.Y. 1990), *aff'd*, 130 B.R. 403 (S.D.N.Y. 1991); *In re Allegheny Int'l, Inc.*, 100 B.R. 247, 250-52 (Bankr. W.D. Pa. 1989).

⁶⁰ Bankruptcy Code § 1122(a). The precise parameters of this requirement are uncertain. For example, courts have refused to permit a plan proponent to classify trade and institutional creditors separately where the classification was designed to ensure satisfaction of § 1129(a)(10), which requires acceptance of the plan by at least one impaired class. *In re Pine Lake Village Apartment Co.*, 19 B.R. 819, 828-31 (Bankr. S.D.N.Y. 1982). Yet they may be separately classified if institutional creditors agree to accept their distribution in the form of debt but trade creditors wish to receive cash. 5 Collier, *supra* note 59, ¶ 1122.04, at 1122-21. See generally Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 Am. Bankr. L.J. 293 (1982) (discussing the enforcement of subordination by classification and assignment).

⁶¹ See Bankruptcy Code § 1125. Section 1125 requires that the disclosure statement contain "adequate information," defined as information sufficient to "enable a hypothetical reasonable investor . . . to make an informed judgment about the plan." *Id.* The intent is to provide investors with information analogous to that required under the securities laws, while at the

the affirmative votes of each class of claims or interests to confirm a consensual reorganization plan.⁶² Section 1126(f) provides, however, that a class that is not "impaired" under the plan is conclusively presumed to have accepted the plan,⁶³ and thus the plan proponent need not solicit acceptances from such a class. The language of section 1126 is indirect and its legislative history unclear, but its apparent denial to members of unimpaired classes of the right to vote⁶⁴ constitutes a significant exception to the universality of the chapter 11 franchise.

For a class to be unimpaired, its treatment under the plan must meet one of three requirements. The plan must: (1) fully preserve the legal, equitable, and contractual rights of each claimant; (2) cure any default under and reinstate the terms of each claim; or (3) pay the allowed amount of each claim in full, in cash, on the effective date of the plan.⁶⁵ Section 1126(f), the "deemed acceptance" provision, reflects the drafters' conclusion that a class that meets any of these requirements has no grounds for complaint and thus no need to vote.⁶⁶

same time ensuring that the requirement not be excessively onerous for the plan proponent. Report of the Committee on the Judiciary, H.R. Rep. No. 595, 95th Cong., 1st Sess. 226-31 (1977), reprinted in 1978 U.S.C.C.A.N. 5963 [hereinafter House Report].

⁶² If one or more of the classes of claimants or interest holders of the firm rejects the plan, the plan may still be confirmed under the cramdown provisions of Bankruptcy Code § 1129(b). The most important requirement of § 1129(b) is the absolute priority rule, which prohibits a class of claims or interests from participating in the plan unless all higher priority claimants have been paid in full. See Bankruptcy Code § 1129(b)(2); David A. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After Ahlers*, 63 Am. Bankr. L.J. 221, 222 (1989).

⁶³ Conversely, under Bankruptcy Code § 1126(g), a class that would receive nothing under a plan is presumed to have rejected the plan.

⁶⁴ Fogel, *supra* note 53, at 154-55. Section 7-309 of the bill proposed by the Bankruptcy Commission stated explicitly that creditors not "materially and adversely affected" by a plan would not be entitled to vote. Report of the Commission on the Bankruptcy Laws of the United States, pt. II, H.R. Doc. No. 137, 93d Cong., 1st Sess. 250 (1973).

⁶⁵ Bankruptcy Code § 1124.

⁶⁶ That satisfaction of any one of the requirements will leave a class unimpaired does not mean that the requirements are interchangeable. Reinstating the terms of a bond that is currently trading well below face value, for instance, would be significantly less costly to the debtor than repaying the bondholder in full as of the effective date of the plan. Rather than paying its full value, in cash, the debtor could repurchase the reinstated bond at its discounted market value immediately after bankruptcy. See Roe, *supra* note 18, at 545-47.

*B. A Normative Assessment of the (Nearly) Universal
Suffrage of Chapter 11*

This Section looks at the chapter 11 voting rules described above through the lens of the contractual analysis developed in Part I. This return to the earlier framework addresses the question whether the chapter 11 franchise is responsive to the same normative concerns as shareholder voting outside of bankruptcy, or whether chapter 11 voting is of an entirely different character.

1. Applying the Residual Ownership Prong to Chapter 11 Suffrage

At first blush, the chapter 11 voting regime seems wholly inconsistent with the residual ownership perspective on corporate voting. Recall that this view of corporate voting justifies shareholders' exclusive right to vote as necessary to vest decisionmaking power in the firm's optimal decisionmakers, its residual owners. In affording every constituency access to the voting process, chapter 11 abandons the goal of limiting suffrage to the single constituency with the best decisionmaking incentives. The true residual owners vote, but so do numerous classes whose decisionmaking incentives are less desirable.

The analysis is not so simple as this characterization suggests. Consider first the fact that because chapter 11 not only effects a sale of the firm's assets, either to its current claimants and interest holders or to a third party,⁶⁷ but also compromises the claims of most or all classes of claimants, multiple constituency voting is inevitable. Were the vote concerned solely with an issue of general applicability—such as whether to consummate a sale of the firm's assets—a single class of claimants could make the decision on behalf of all of the firm's constituencies. But realistically the drafters of the Code could not have meant to give a single class of claims the authority to determine whether and how to compromise the claims of another class. A rule permitting one class of creditors to alter the claims of another class

⁶⁷ Robert Clark first pointed out that the reorganization (and scaling down) of the debts of a firm is, in effect, a "sale" of the firm to its current creditors. Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 *Yale L.J.* 1238, 1250-54 (1981). Although critics of the law-and-economics school believe this analogy ignores the multiplicity of values at stake in chapter 11, see, e.g., Korobkin, *supra* note 2, at 749-55, 759-61, the metaphor is a useful tool for developing a full understanding of the complexity of chapter 11.

would create a huge risk of opportunistic behavior by the decision-making class.⁶⁸

More important, despite the inevitability of multiple constituency voting, the Bankruptcy Code still seems to focus voting authority on the residual class. The residual class is the first class that will be impaired if the plan proponent seeks to compensate as many classes in full as the firm's assets will allow. Because unimpaired classes of claims or interests are deemed to accept a reorganization plan, full compensation eliminates the ability of a class to vote against the plan. Therefore, the residual class will vote in nearly every chapter 11 case (unless the reorganization plan proposes to pay the residual owners in full but impairs a higher class), and its vote frequently will prove pivotal.

Admittedly, the use of deemed acceptances substitutes imperfectly for a precise determination of the true residual owner. In practice, for instance, reorganization plans often reflect negotiated compromises that impair all but the most senior creditors, and thus numerous constituencies vote. That various classes participate is not inconsistent with the suggestion that the vote of the residual class is crucial, however, for the residual class is the highest priority class whose vote the plan proponent *must* get, given that the residual class invariably will be impaired.⁶⁹

The following illustration may help clarify the analysis. Suppose that a corporation, with assets of \$1 million, has filed a chapter 11 petition. Claims against the corporation total \$1.3 million: \$500,000 owed to the secured creditors, and \$400,000 each owed to the general unsecured creditors and the subordinated unsecured creditors, with the shareholders entitled to any residual. The corporation, as debtor in possession, proposes a reorganization plan consisting of a sale of

⁶⁸ Such opportunism probably could be controlled only by strictly limiting the decisionmaker's latitude. Chapter 13 of the Bankruptcy Code arguably reflects such a regime.

⁶⁹ An interesting analogy can be drawn between the analysis in the text and the median voter theorem developed by Harold Hotelling and other public choice theorists. In its simplest form, the median voter theorem suggests that each of the parties in a two-party representative democracy will be driven toward the viewpoint of the median voter, somewhat as I have argued that the chapter 11 voting rules tend to focus attention on the residual ownership class. The dynamics of an actual election, like those of a bankruptcy case, are much more complex than the unimodal, symmetric preference assumptions of the original model would suggest. Consequently, subsequent theorists have refined the theorem to begin to account for some of these complexities. See Dennis C. Mueller, *Public Choice II*, at 179-95 (1989).

the corporation to a third party for \$1 million and distribution of the proceeds as follows: \$500,000 to the secured creditors, \$250,000 to the general unsecured creditors, \$150,000 to the subordinated unsecured creditors, and \$100,000 to the shareholders.

Because the plan proposes to pay the secured creditors in full, they are unimpaired and may not vote. The general unsecured creditors may vote, but the corporation can silence their class if necessary by proposing to pay them their full \$400,000.⁷⁰ The corporation enjoys no such luxury with respect to the subordinated unsecured creditors because compensating the prior two classes in full would leave only \$100,000 for the subordinated unsecured creditors. As a result, the corporation cannot pass a consensual plan without the support of subordinated unsecured creditors,⁷¹ and therefore their vote should play an important role in the plan process.

The shareholders are similarly situated in that the corporation cannot pass a consensual plan without their support.⁷² The possibility of a cramdown tempers the importance of their vote, however. If the shareholders refuse to vote for a plan supported by the corporation's other constituencies, the corporation can threaten to amend its plan to comply with the absolute priority rule⁷³ under which, in the event the plan proponent fails to obtain the approval of every class, no class of claims or interests may participate in the reorganization unless all superior classes have been compensated in full. Because the shareholders would receive nothing under such a plan, and because every constituency is likely to be aware of this fact, the shareholders should have less leverage than the subordinated unsecured creditors, the firm's true residual class.⁷⁴

⁷⁰ This "silencing" process is extremely expensive, and debtors cannot usually afford to pay many classes in full. Nevertheless, something like this does go on—senior creditors usually get very near their full claim. Their willingness to accept slightly less than full payment reflects their recognition that failure to compromise may result in costly delay. The effect of this is, at least in a general way, to focus attention on unsecured creditors.

⁷¹ Bankruptcy Code § 1129(a)(8) (requiring acceptance by every impaired class).

⁷² *Id.*

⁷³ See *id.* § 1129(b)(2); *supra* note 62.

⁷⁴ This effect is vitiated if the parties do not perceive cramdown as a viable option. See *supra* note 62; *infra* Part II.C.

2. *Applying the Contractual Safeguard Prong to Chapter 11 Suffrage*

The expanded suffrage of chapter 11 also makes sense from a contractual safeguard perspective. Recall that this view of corporate voting justifies shareholders' exclusive right to vote as compensation for shareholders' peculiar inability contractually to safeguard their interests.⁷⁵

The distinction between shareholders and other constituencies in this regard breaks down in bankruptcy. Several Bankruptcy Code provisions significantly undermine the efficacy of other constituencies' contractual protections. First, the filing of a chapter 11 petition triggers an automatic stay of all efforts to collect a debt from or otherwise enforce rights against the debtor.⁷⁶ Thus, a secured lender loses (at least temporarily) the right to repossess her collateral in satisfaction of amounts owed. Second, the Bankruptcy Code neutralizes the effect of lenders' default and acceleration clauses. The Code permits the firm to reinstate the maturity of a loan, notwithstanding any prebankruptcy defaults;⁷⁷ after bankruptcy, the lender has no choice but to continue a contractual relationship it otherwise would have been entitled to terminate.⁷⁸ Finally, bankruptcy provides management with a means of forcing employees to renegotiate and make midstream concessions with respect to the terms of collective bargaining agreements and other contracts. Despite the enactment of sections 1113 and 1114

⁷⁵ See *supra* Part I.B.

⁷⁶ Bankruptcy Code § 362.

⁷⁷ *Id.* § 1124.

⁷⁸ See, e.g., Jackson, *Creditors' Bargain*, *supra* note 2, at 887-92 (suggesting that the Bankruptcy Code's nonrecognition of *ipso facto* clauses undermines creditors' bargained-for entitlements). Could a lender whose loan was reinstated attempt to accelerate immediately after bankruptcy, claiming that she is "insecure"—that she had a good faith belief her collateral value had been impaired, as required by U.C.C. § 1-208? Courts likely would not permit such an action.

to curb the perceived abuse of this weapon,⁷⁹ the status of such contracts remains uncertain in bankruptcy.⁸⁰

Nevertheless, bankruptcy does not completely negate the effectiveness of contractual safeguards. Though the automatic stay and the debtor's right to reinstate weaken the posture of creditors, the Code recognizes the importance of preserving creditors' bargained-for entitlements. Perhaps the most significant manifestation of this policy is the absolute priority rule.⁸¹ In a sense, the absolute priority rule substitutes for the parties' bargained-for contractual rights. Secured creditors, for instance, bargained most fully as a class to protect their interests outside of bankruptcy.⁸² Bankruptcy neutralizes many of the contractual safeguards of secured creditors, but, in their stead, the absolute priority rule ensures that even in chapter 11 secured creditors can insist upon compensation prior to any other class.⁸³ Thus, secured creditors stand first in line in chapter 11 (and may veto any reorganization plan that attempts to deviate from this standard), just as they do outside of bankruptcy. Similarly, a senior class of bondholders takes priority over the holders of subordinated bonds, and stockholders still are entitled only to any residual interest.

⁷⁹ Bankruptcy Code § 1113 provides that collective bargaining agreements may not be set aside in bankruptcy unless three conditions exist: (1) the trustee has bargained with the union in an attempt to reach a mutual agreement; (2) the union has rejected the trustee's proposals without good cause; and (3) the "balance of equities" clearly favors rejection of the agreement. Section 1114 sets up similar restrictions on modifications of employee retirement plans.

⁸⁰ See, e.g., Anne J. McClain, Note, Bankruptcy Code Section 1113 and the Simple Rejection of Collective Bargaining Agreements: Labor Loses Again, 80 Geo. L.J. 191 (1991).

The uncertainty of employees' pension benefits under § 4047 of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1347 (1988), is amply attested to by *Pension Benefit Guaranty Corp. v. LTV Corp.*, 110 S. Ct. 2668 (1990), in which the United States Supreme Court held that the Pension Benefit Guaranty Corporation did not act arbitrarily and capriciously in restoring LTV's pension plans. Nevertheless, LTV continued to argue that it could not be compelled to make payments to the restored plans because even with such payments the plans would probably be unable to satisfy outside debts. See *Pension Benefit Guaranty Corp. v. LTV Corp.*, 122 B.R. 863 (S.D.N.Y. 1990) (rejecting this argument, but agreeing that the Supreme Court had left it open); see also Kurtzman, *supra* note 34, at 2 (Columbia Gas System Inc. files chapter 11 petition to force renegotiation of long-term contracts with its natural gas suppliers).

⁸¹ Bankruptcy Code § 1129(b)(2); see *supra* note 62.

⁸² Taking security significantly reduces a creditor's exposure. Because of the reduced risk, a secured creditor can charge a relatively lower interest rate. See Scott, *supra* note 2, at 694.

⁸³ Secured creditors also can seek relief from the automatic stay to foreclose on their collateral under Bankruptcy Code § 362(d), which authorizes relief if the secured creditor's collateral is not "adequately protected" or if the debtor has no equity in the collateral and the collateral is not necessary to an effective reorganization.

Even with the surrogate safeguards provided by chapter 11, however, the firm's creditors are far more exposed than before bankruptcy. The absolute priority rule provides broad protection in theory, especially for secured creditors, but its dictates are easily undermined in practice. For instance, courts and the firm's other constituencies view the cramdown provisions of section 1129(b) as a costly and thus undesirable alternative to consensual reorganization because cramdown requires a complete valuation of the firm's assets.⁸⁴ Moreover, in those cases involving a cramdown, the court must make not only an initial valuation of the secured creditor's collateral, but perhaps also a determination of whether a proposed plan will yield her the "indubitable equivalent" of her secured interest, as required by the absolute priority rule.⁸⁵ It is widely believed that secured creditors tend not to get the benefit of their bargain on either occasion.⁸⁶ Finally, unless a creditor is oversecured, its claim ceases accruing interest after the filing of the chapter 11 petition.⁸⁷ Undersecured creditors therefore receive no compensation for the delay in enforcing their contractual rights. The Bankruptcy Code safeguards protecting employees are, as noted above, equally provisional and limited in scope.

Thus, the overall effect of chapter 11 is to undermine creditors' contractual safeguards considerably. The Bankruptcy Code ultimately returns, in the form of surrogate protections, much less than it takes away. As a result, the imbalance between shareholders' need for generalized contractual safeguards such as voting rights, and that of employees and other creditors, is significantly reduced in bankruptcy. Because shareholders no longer have a superior normative claim to the franchise, the contractual safeguard approach implies that each

⁸⁴ See 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, 143-58 (1990). LoPucki and Whitford conclude that several other factors, including fear of delay and (most importantly) the "intermediated" nature of chapter 11, also contribute to the parties' negative view of cramdown. *Id.*

⁸⁵ Bankruptcy Code § 1129(b)(2)(A)(iii).

⁸⁶ See, e.g., Jackson, *Creditors' Bargain*, *supra* note 2, at 872-77.

⁸⁷ Bankruptcy Code § 506(b). The Supreme Court has rebuffed creditors' efforts to circumvent this rule by seeking payment of lost opportunity costs under Bankruptcy Code § 362(d)(1), which deals with "adequate protection" of a claim. *United Sav. Ass'n v. Timbers of Inwood Forest Assoc.*, 484 U.S. 365 (1988).

constituency should be, as it is, entitled to vote if its members are impaired by the reorganization plan in question.

The preceding analysis suggests that chapter 11 decisionmaking parallels in important respects the corporate voting rules applicable outside of bankruptcy. The voting process focuses authority on the firm's residual owner, yet the expanded franchise is consistent with the parties' need for contractual safeguards. Nonetheless, negotiations among the constituencies in chapter 11 often seem to produce voting results that no single class would have chosen. The following Sections will examine one of the causes of this problem.

C. Shareholders' Role in the Chapter 11 Voting Process

Although chapter 11's voting rules focus attention on the residual class, the rules cannot completely eliminate the multiple peak problem⁸⁸ that arises whenever parties with divergent and often conflicting interests make decisions.⁸⁹ The presence of the shareholder constituency in particular most distorts decisionmaking in chapter 11. As the illustration above suggests, shareholders usually have lost their residual owner status by the time a corporation enters chapter 11.⁹⁰ Because chapter 11 debtors typically are insolvent (though the Bankruptcy Code requires no proof of this), the new residual owners of a publicly held firm are likely instead to be its unsecured creditors, or, as in the illustration, a subclass thereof.⁹¹

In contrast to the shareholders of a flourishing business, whose incentives further the firm's wealth-maximization goal, shareholders of an insolvent corporation pursue a separate agenda because they

⁸⁸ See *supra* note 38 and accompanying text.

⁸⁹ 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, 160 (1989) ("the law cannot ensure that the interests of any particular group of claimants will coincide with this interest of the whole"); Roe, *supra* note 18, at 538-40 (arguing that the parties' negotiations are subject to significant hold-up risks, due to the numerous parties involved, and that, simply to reach agreement, the parties often agree to more debt than is appropriate for the firm's capital structure).

⁹⁰ See, e.g., LoPucki & Whitford, *supra* note 84, at 141-43. LoPucki and Whitford conducted an extensive empirical study with respect to 43 firms that filed chapter 11 petitions after October 1, 1979—each declaring assets in excess of \$100 million. Of the 43 firms, LoPucki and Whitford concluded that 30 were insolvent (at least as of the confirmation date).

⁹¹ For closely held firms, this often may not be the case. The principal creditor of a small corporation frequently is a secured lender who holds a security interest in all of the firm's assets. If such a lender is undersecured, it can be seen as the true residual owner.

will receive nothing upon an immediate liquidation. First, shareholders may wish to prolong the chapter 11 case as long as possible in the hope that the firm's fortunes will improve.⁹² Second, they will encourage gambling with the assets of the firm because they have nothing to lose, and everything to gain, if the firm takes extraordinary business risks.⁹³

Given shareholders' questionable incentives, one could argue that shareholders' role in the decisionmaking process should be constrained or even eliminated once a firm enters chapter 11. Yet the chapter 11 voting framework has precisely the opposite effect in practice, given the rarity with which cramdown provisions are invoked. Because the emphasis in most chapter 11 cases is on consensual reorganization, the plan proponent must secure shareholders' support, notwithstanding shareholders' lack of entitlement to any distribution in a cramdown situation. Shareholders obviously will, and do, exact a price for their voting support.

The question that emerges is whether chapter 11 should eliminate shareholders' voting rights if the firm is insolvent.⁹⁴ Withholding the franchise from shareholders would further focus decisionmaking authority on the true residual class. Moreover, limiting shareholders' right to vote in this fashion is not unfair to shareholders because arguably they have no financial interest in an insolvent firm.

At least two arguments can be made in support of the current voting regime, however. First, were an insolvent firm liquidated today,

⁹² Jackson & Scott, *supra* note 89, at 158-59 (noting that lower classes want the debtor to continue in business because they expect to fare poorly in a liquidation).

⁹³ *Id.* The bankruptcy of Arlan's Department Stores ("Arlan's") offers a vivid example of this phenomenon. After Arlan's filed for bankruptcy relief in 1970, its managers engaged in a last-ditch effort to reverse the store's fortunes. They spent a significant portion of its funds hiring (without court approval) a special consultant, who directed an elaborate campaign that involved altering the layout of the stores, stocking new and different merchandise, and conducting a costly promotional campaign. This step was designed to maximize Arlan's profits during the 1973 Christmas shopping season. Sadly, the campaign failed, and Arlan's subsequently was liquidated. See *In re Arlan's Department Stores*, 462 F. Supp. 1255, 1259 (S.D.N.Y. 1978), *aff'd*, 615 F.2d 925 (2d Cir. 1979).

⁹⁴ Both Mark Roe and Lucian Bebchuk, each of whom has offered a dramatically new model for chapter 11 reorganization, have designed new systems that tend toward strict adherence to the absolute priority rule and thus would have a similar effect. See Lucian A. Bebchuk, *A New Approach to Corporate Reorganization*, 101 Harv. L. Rev. 775 (1988) (proposing that claimants and interest holders be given tradable options in the reorganized entity); Roe, *supra* note 18 (proposing an all-equity capitalization, the value of the equity to be determined by offering 10% for sale on the market).

shareholders would have no financial interest in the proceeds, but so long as the firm continues to operate there is a chance that its fortunes will improve dramatically and again give value to the shareholders' ownership interest. This possibility of future value, discounted to the present, represents shareholders' financial interest in an insolvent firm.

Second, permitting shareholders to participate in the chapter 11 process may be necessary to create the proper incentives to enter bankruptcy.⁹⁵ If shareholders were entirely excluded from the process, managers of an insolvent firm might prefer to delay going into bankruptcy rather than risk sacrificing shareholders' interests to the good of the firm as a whole. Notice that neither of these arguments denies that shareholders' incentives are suboptimal and that their presence thus tends to skew the decisionmaking process. Rather, each argument suggests that shareholders should retain their voting rights despite this fact.

Lynn LoPucki and William Whitford have suggested a possible compromise position. They argue that courts could find in an appropriate case that the shareholders have no plausible entitlement to participate in any distribution and therefore are not a party in interest.⁹⁶ Their rule would eliminate shareholder suffrage with respect only to a chapter 11 debtor whose debts far exceed its assets.⁹⁷

It is beyond the scope of this Article to assess fully the various positions on this thorny issue. The important point for present purposes is that because chapter 11 permits shareholders to vote even in contexts where their incentives are skewed, and because the parties seldom resort to cramdown, shareholder suffrage often undermines the efficiency of the chapter 11 franchise.

⁹⁵ See Alan Schwartz & Robert E. Scott, *Commercial Transactions: Principles and Policies* 887 (2d ed. 1991).

⁹⁶ LoPucki & Whitford, *supra* note 84, at 186.

⁹⁷ *Id.* One question that might arise with respect to the LoPucki and Whitford proposal is whether courts ever would invoke it. One suspects that courts would be exceedingly willing to find some hope of an equity recovery, especially if the determination were made early in the case.

D. The Majority in Number/Two-Thirds in Amount Voting Requirement

As discussed earlier, the one-share, one-vote requirement for shareholder voting outside of bankruptcy is explained by the direct relationship between the number of shares owned and the financial stake in the firm. Accounting for creditors' interests proves more difficult, for their claims differ vastly in origin and amount. As a result, chapter 11 requires not only that a majority in number of the claims in a class approve a reorganization plan, but also that two-thirds of the total amount vote in favor. The voting standard thus includes aspects both of a majority and of a supermajority standard.⁹⁸

In practice, the two-thirds in amount prong is the more significant hurdle because a plan proponent who secures the affirmative votes of two-thirds in amount of the claims in a class usually also will have secured well over a majority in number.⁹⁹ Section 1126(c) has, therefore, the effect of a simple supermajority requirement. Section 1126(d) makes this explicit with respect to shareholders by requiring as a prerequisite to acceptance that two-thirds in amount of a class of interests cast their votes in favor of a plan.

Why then was a supermajority standard adopted for the purposes of chapter 11 voting? The legislative history sheds little light on this question, even though the two-thirds acceptance requirement deviates both from the old chapter XI voting standard and from the recom-

⁹⁸ The voting requirement of Bankruptcy Code § 1126(c) derives in part from old Chapter X and in part from old Chapter XI. Section 179 of Chapter X based acceptance on the affirmative vote of two-thirds in amount of the claims in a class. 11 U.S.C. § 579 (repealed). Section 362(1) of Chapter XI, on the other hand, required acceptance by a majority in amount and a majority in number. 11 U.S.C. § 762(1) (repealed). Bankruptcy Code § 1126 deviates from its antecedents in that, whereas old §§ 179 and 362 required the appropriate majorities of all claims in a class, regardless of whether the claimants voted, § 1126 requires only a majority in number and two-thirds in amount of the claims actually voted. Thus, failure to vote is no longer equivalent to rejection. See 5 Collier, *supra* note 59, ¶ 1126.03, at 1126-11 to -12.

⁹⁹ This generalization may not hold true if the class contains claims of disproportionate size. Another possible deviation results from the trading of bankruptcy claims. If an investor purchases large numbers of claims in a particular class, a court might give her only a single vote, rather than one vote for each claim. See Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 Cardozo L. Rev. 1, 36-91 (1990). The effect would be to dilute the claimant's voting power and, in an extreme case, to enhance the importance of the majority-in-number requirement.

mendations of the 1973 Report of the Commission on the Bankruptcy Laws, each of which provided for simple majority voting.¹⁰⁰

Two concerns undoubtedly played a role in the drafters' choice. First, reorganization plans effect an alteration of the prebankruptcy contractual rights of dissenting voters against their wishes. Although the constitutionality of the Bankruptcy Code provisions that bind dissenters to the majority will has long been settled,¹⁰¹ the drafters may have concluded as a matter of policy that a supermajority vote was needed to justify such an effect.

Second, like shareholders, the creditors of a publicly held corporation may be small and dispersed enough so that they have insufficient incentives to cast their votes in an informed fashion for or against a reorganization proposal.¹⁰² Because this would give a plan proponent the upper hand,¹⁰³ the drafters may have concluded that the proponent should be required to secure the support of two-thirds of the voters, in effect using the supermajority requirement as a partial response to voters' collective action problems.

Whatever the rationale, the drafters' adoption of a supermajority standard is misguided. Consider how supermajority voting is used in close corporations, the most prevalent context of such arrangements. In contrast to the shareholders of publicly held corporations, shareholders of close corporations are both investors and managers.¹⁰⁴ Supermajority voting standards protect the minority shareholders of a closely held firm by giving them veto power over business decisions. A minority shareholder's major fear is that the majority shareholders may one day limit or cut off her access to the income generated by the firm.¹⁰⁵ To protect herself, the minority shareholder of a four-share-

¹⁰⁰ On the other hand, the two-thirds voting requirement is consistent with former Chapter X. See *supra* note 98.

¹⁰¹ See *infra* notes 120-21 and accompanying text.

¹⁰² See *infra* Part IV for a discussion of creditors' collective action problems in chapter 11.

¹⁰³ Moreover, many of the voters in question are likely to be trade creditors, whose rational apathy is intensified by their willingness to accept any payment—however small—rather than face further delay.

¹⁰⁴ See, e.g., Del. Code Ann. tit. 8, § 351 (1983) (charter of close corporation may contain provision providing that the shareholders rather than directors manage the corporation).

¹⁰⁵ As John Hetherington, Michael Dooley, and others have pointed out, because there is unlikely to be a market for minority interests in a closely held firm, minority shareholders could be trapped in the event the majority turns against them. E.g., J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 Va. L. Rev. 1, 5-6 (1977).

holder firm, for example, would desire adoption of an eighty percent voting requirement, for this would ensure that the other three shareholders could never fire her or vote themselves pay raises without giving her a comparable raise.

Minority protection comes at a price, however. A minority shareholder may also use her veto power strategically, as a weapon designed to extract concessions from the remaining shareholders. This cost is justified, and supermajority voting is thus desirable, if the actions taken by majority shareholders could have a disproportionate effect on the minority, as in a close corporation.¹⁰⁶ The franchise operates very differently in chapter 11, however. The chapter 11 vote determines whether a class accepts or rejects the terms of a particular reorganization plan. If the class votes in favor of a plan, and the plan is confirmed, every member of the class receives exactly the same distribution.¹⁰⁷ Similarly, rejection of the plan precludes any member of the class from receiving a distribution until such time as another plan is proposed and confirmed. Because each member of the class is affected in the same way by the outcome of the vote, there is no need to impose supermajority voting as a protective device.¹⁰⁸ For similar reasons, whereas states traditionally have required the approval of two-thirds of a firm's shareholders to effect fundamental corporate changes such as mergers, the current trend clearly is toward simple majority voting in these contexts.¹⁰⁹

E. Positive Aspects of the Analogy Between Chapter 11 Voting and Voting Under State Corporate Law

This Part began with the observation that sections 1121 to 1129 of the Bankruptcy Code displace state corporate voting provisions with

¹⁰⁶ See *id.*; see also Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 *Stan. L. Rev.* 271, 296-97 (1986) (arguing that, in deciding whether a minority shareholder in the close corporation context has violated a fiduciary duty by blocking a decision, courts should consider whether the decision in question was likely to have had a disproportionate impact).

¹⁰⁷ See Bankruptcy Code § 1123(a)(4).

¹⁰⁸ See Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 *Yale L.J.* 1354, 1357 (1978). This is not to say that class members will never have divergent interests or ulterior motives: a trade creditor may have a vested interest in the continued existence of the company, for instance, or other investors ultimately may wish to take the company over. Rather, the point is that class members cannot use differential treatment within the class as a means of acting on such motives.

¹⁰⁹ See, e.g., *Del. Code Ann. tit. 8, § 251* (Supp. 1990).

what appears to be a largely unrelated voting regime. I suggested thereafter that the apparent divergence is misleading; the chapter 11 franchise is surprisingly consistent with the residual ownership and contractual safeguard perspectives that justify the shareholders' monopoly of the franchise outside of bankruptcy. Yet the dramatic superficial distinctions remain. It is helpful at this point to enrich further the comparison between the two schemes. The remainder of this Part demonstrates that, in addition to working on a normative level, the analogy between chapter 11 suffrage and voting outside of bankruptcy is also descriptively plausible.

If state corporate governance rules rather than the Bankruptcy Code governed chapter 11 reorganization, the reorganization would give rise to shareholders' voting rights for each of two reasons. First, chapter 11 effects a sale of all or substantially all of the firm's assets, either to a third party (if there is an explicit sale) or to the firm's current creditors through the reorganization process.¹¹⁰ Second, chapter 11 leads to a substantially altered corporate charter: for instance, it requires the inclusion in a reorganized firm's charter of a provision prohibiting the issuance of nonvoting stock¹¹¹ and also permits the firm (with the appropriate vote) to alter the rights of its current interest holders and to issue new stock.¹¹²

Although this recharacterization of chapter 11 helps explain the existence of voting rights, we still need to explain from a positive perspective why only one class of shareholders votes outside of bankruptcy, whereas the franchise is nearly universal in chapter 11. The missing link between these apparently divergent voting regimes can be found in the special class voting rules applicable outside of bankruptcy. Most state corporation statutes require that the holders of outstanding shares of a class be permitted to vote on any amendment that alters the nature of their stock, even if the affected shareholders would not otherwise be entitled to vote.¹¹³ To pass, such an amendment must be favored by a majority of all stockholders entitled to vote

¹¹⁰ See Clark, *supra* note 67.

¹¹¹ Bankruptcy Code § 1123(a)(6).

¹¹² See *id.* § 1123(a)(5)(H) (authorizing the "extension of a maturity date or a change in an interest rate or other term of outstanding securities"); *id.* § 1123(a)(5)(I) (contemplating amendment of the firm's charter).

¹¹³ See Del. Code Ann. tit. 8, § 242(b)(2) (1983).

and also by a majority of those in the affected class.¹¹⁴ Thus, even without the Bankruptcy Code, common shareholders' usual monopoly on suffrage would give way to a more broadly inclusive regime once chapter 11 events occurred.¹¹⁵

The analogy between state corporate law voting rules and those applicable in chapter 11 also has a historical dimension. In the late nineteenth century, fundamental changes such as mergers and charter amendments required unanimous shareholder approval.¹¹⁶ This standard protected the interests of minority shareholders, as intended, but also impaired firms' ability to adjust to their markets and to take desirable entrepreneurial risks, because any proposal could be vetoed by a single shareholder.¹¹⁷

Subsequent state corporation statutes tried to accommodate both goals. To enhance the firms' flexibility, states replaced the unanimity requirement with majority voting. Minority shareholders were compensated for their loss of protection with appraisal rights.¹¹⁸ This remedy allows a shareholder who is dissatisfied with a merger, or other fundamental change in the firm approved by a majority, to demand that the corporation repurchase her shares at a price deter-

¹¹⁴ *Id.* § 242(b)(1).

¹¹⁵ Although special class voting rules apply specifically to changes involving shares of stock, the analogy easily extends to alterations of creditors' claims. For example, the firm cannot alter the terms of a bond absent approval of the holders who would be affected. Outside of bankruptcy, even supermajority approval often will not suffice to effect such a change. See Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 *Yale L.J.* 232 (1987) (criticizing § 316 of the Trust Indenture Act, which prohibits modification of the core terms of a bond without the bondholders' unanimous consent). As a result, firms sometimes resort to bankruptcy when they wish to alter (that is, scale down) bond terms. See *In re The Southland Corp.*, 124 B.R. 211 (Bankr. N.D. Tex. 1991); George Anders, *Memorex Plans 'Prepackaged' Bankruptcy*, *Wall St. J.*, July 17, 1991, at A3 (discussing Memorex's plan to file a chapter 11 petition, together with a prenegotiated reorganization plan, to restructure \$1.3 billion in debt); Barbara Demick, *The Rise of Instant Bankruptcy*, *Phila. Inquirer*, Aug. 4, 1991, at D1 (describing the use of "prepackaged" bankruptcies to scale down debts and quickly emerge from chapter 11).

¹¹⁶ *Armstrong v. Marathon Oil Co.*, 513 N.E.2d 776, 782 (Ohio 1987); Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 *N.Y.U. L. Rev.* 624, 627 (1981).

¹¹⁷ American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* 607-09 (Tent. Draft No. 11, 1991).

¹¹⁸ Weiss, *supra* note 116, at 624-28. But see Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 *UCLA L. Rev.* 429, 430 (1985) (questioning the view that the elimination of shareholder unanimity requirements prompted the advent of the appraisal remedy).

mined in court.¹¹⁹ Not surprisingly, minority shareholders rebelled at the substitution of appraisal rights for their former veto power. Disgruntled minority shareholders challenged the state law provisions permitting a corporation to alter the terms of its stock and to effect other amendments to its charter against the dissenters' wishes as violative of the Contracts Clause in Article I of the Constitution. These protests paid off in a few of the early cases,¹²⁰ but subsequent complaints have proven fruitless.¹²¹

Developments in bankruptcy law have followed a very similar pattern. As with corporations outside of bankruptcy, reorganization efforts in the nineteenth century were hampered by an inability to bind minorities. An amendment to the Bankruptcy Act of 1898, section 77B, remedied this problem by establishing a system of majority rule and thus eliminating the need to resort to cumbersome equity receiverships as a means of effecting a corporate reorganization.¹²² The current Bankruptcy Code can be seen as compensating minority claimants for their loss of clout by providing what arguably is a counterpart to corporate law appraisal rights.¹²³ Section 1129(a)(7) of the

¹¹⁹ See, e.g., Del. Code Ann. tit. 8, § 262 (1983).

¹²⁰ See, e.g., *Keller v. Wilson & Co.*, 190 A. 115, 125 (Del. 1936) (Contracts Clause prohibited charter amendment that eliminated accrued and unpaid dividends, despite majority approval, because accrued dividends constituted a vested property right.); *Keller* was subsequently undercut by *Federal United Corp. v. Havender*, 11 A.2d 331 (Del. 1940), which held that a corporation could achieve the same effect through a merger. See *Hottenstein v. York Ice Mach. Corp.*, 136 F.2d 944, 950 (3d Cir. 1943).

¹²¹ See, e.g., *Goldman v. Postal Tel.*, 52 F. Supp. 763, 769 (D. Del. 1943):

Since the corporation is the creature of the state, and since the corporation law is a part of the corporate charter, it is self-evident the state has the right to reserve to itself, or a majority or more of the stockholders, the power to change the contract between the corporation and its stockholders or between its different classes of stockholders by an amendment to the charter after such contracts are made, even if a particular class of stockholders must suffer slightly.

¹²² Act of June 7, 1934, ch. 424, 48 Stat. 911, 913-14 (1934); see John Gerdes, *Corporate Reorganizations Under Section 77B of the Bankruptcy Act* § 20, at 64 (1936). Prior to section 77B, firms reorganized through a fictional sale in equity receivership. A major problem with this process was the necessity of cashing out every minority claimant or shareholder who dissented from the plan. *Id.* § 17, at 55-56.

¹²³ Section 77B(b)(5)(c) had provided for appraisal and payment of a class of claims that voted against a proposed reorganization plan but did not make specific provision for dissenting claimants in a class that, as a whole, approved the plan. VIII Securities and Exchange Comm'n, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees* 138, 141 n.215 (1940). In theory at least, these claimants were protected by the requirement that every reorganization plan satisfy the dictates of the absolute priority rule. *Id.* at 151-52.

Bankruptcy Code provides that the bankruptcy court cannot confirm a reorganization plan unless the dissenting members of a class that votes in favor of the plan will receive as much or more than the amount they would receive in a liquidation.¹²⁴ Like their corporate law counterparts, disgruntled claimants initially resisted these developments and contended that the bankruptcy laws facilitated impairment of their contractual rights. Courts have rejected these arguments and have upheld the bankruptcy provisions that bind minorities just as they affirmed analogous sections in state corporation law statutes.¹²⁵

III. AN ANALYSIS OF CHAPTER 11 VOTING ISSUES

As noted in the Introduction, courts and commentators have always characterized chapter 11 solely in terms of the negotiations that take place among the parties. The first two Parts of this Article drew out the analogy between chapter 11 voting rules and state law corporate voting rules from both a normative and a positive perspective. We now are ready to apply the analysis of Parts I and II to three controversial chapter 11 issues: sales of most or all of a firm's assets prior to confirmation, the shareholders' right to compel a shareholders' meeting, and the acquisition and exercise of a blocking position in a class (or classes) of claims. Understanding these issues as voting

¹²⁴ Bankruptcy Code § 1129(a)(7). Interestingly, both § 1129(a)(7) and corporate law appraisal rights have been criticized for failing to give dissenters the full going concern value of their claims. See Jackson, *Creditors' Bargain*, *supra* note 2, at 393 n.168 (suggesting that the liquidation value provided in § 1129(a)(7) should reflect the possibility that liquidation may consist of the sale of the firm intact to a third party); Elmer Schaefer, *The Fallacy of Weighting Asset Value and Earnings Value in the Appraisal of Corporate Stock*, 55 S. Cal. L. Rev. 1031 (1982); Weiss, *supra* note 116, at 680.

Commentators also have criticized the requirements shareholders must satisfy to invoke their appraisal rights. E.g., Joel Seligman, *Reappraising the Appraisal Remedy*, 52 Geo. Wash. L. Rev. 829, 834-36 (1984). In Delaware, for instance, a shareholder must deliver a written demand for appraisal rights to the corporation prior to the vote in question, must demand a valuation within 120 days of the corporate change, and cannot vote her stock or receive dividends while the petition is pending. Del. Code Ann. tit. 8, § 262 (c)-(e), (k) (1983). The Delaware Supreme Court recognized and addressed many of these problems with the appraisal remedy in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983), but was not persuaded that the possibility of synergy gains should be taken into consideration. See American Law Institute, *supra* note 117, at 616.

¹²⁵ *Campbell v. Alleghany Corp.*, 75 F.2d 947, 954 (4th Cir.), cert. denied, 296 U.S. 581 (1935); see Gerdes, *supra* note 122, § 22, at 85-87.

issues helps clarify some of the confusion that has plagued judicial and academic analysis of bankruptcy.

A. Sales of Substantial Assets Prior to Confirmation

Section 363(b)(1) of the Bankruptcy Code authorizes the bankruptcy trustee, after notice and a hearing, to sell assets of the firm outside of the ordinary course of business.¹²⁶ The section clearly contemplates that the trustee may sell minor portions of the debtor's business, such as a particular piece of equipment that the firm would not routinely sell (and might not have sold but for the need to scale down in bankruptcy). What is less clear is whether section 363(b)(1) also gives the trustee the power to sell all or substantially all of the assets of the firm.

1. Judicial Analysis: A Description and a Critique

Two United States Circuit Court of Appeals decisions, *In re Braniff Airways*¹²⁷ and *In re Lionel Corp.*,¹²⁸ have addressed this issue. In *Braniff*, Braniff Airways, Inc. ("Braniff") sought approval of an agreement that not only would have resulted in the sale of Braniff's landing slots to a third party, Pacific Southwest Airlines ("PSA"), but also would have assured shareholders and unsecured creditors a distribution in connection with any subsequent reorganization plan, and that Braniff's secured creditors would cast their votes in favor of the plan.¹²⁹ The United States Court of Appeals for the Fifth Circuit, although recognizing that under certain circumstances a firm may sell most or all of its assets pursuant to section 363(b), struck down this agreement because it purported to "[dictate] some of the terms of any future reorganization plan."¹³⁰

¹²⁶ Bankruptcy Code § 363(b)(1).

¹²⁷ 700 F.2d 935 (5th Cir. 1983).

¹²⁸ 722 F.2d 1063 (2d Cir. 1983).

¹²⁹ In particular, under the agreement with PSA, Braniff would have paid \$2.5 million for \$7.5 million of PSA travel scrip, which it could have issued only to Braniff shareholders and unsecured creditors. The agreement also required Braniff's secured creditors to vote a stated amount of their unsecured deficiency claim in favor of any reorganization plan supported by the unsecured creditors' committee, and provided for the release of any potential claims against, among others, Braniff and its officers and directors. *Braniff*, 700 F.2d at 939-40.

¹³⁰ *Id.* at 940. According to the court, approving this agreement would have improperly circumvented the chapter 11 prerequisites for confirmation—safeguards such as the disclosure

In contrast, in *Lionel* the court addressed directly the sale of most or all assets issue¹³¹ and concluded that such sales should not be approved unless there is "some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business."¹³² The court held that no such justification had been shown after characterizing the standard as an attempt to balance the need for flexibility in furthering the goals of chapter 11 with the loss of chapter 11's disclosure and voting protections when a court approves a sale of most or all of the firm's assets prior to confirmation under section 363(b).¹³³

Following *Braniff* and *Lionel*, courts have recognized that authorizing sales of substantial assets pursuant to section 363 undermines the statutory scheme of chapter 11 and have responded by attempting to devise as a prerequisite to approval their own substitute for chapter 11's protections. Courts typically subject proposals to sell substantial assets to enhanced scrutiny, requiring (as in *Lionel*) the debtor or other applicant to demonstrate a "good business reason" or an "articulated business justification" for the sale.¹³⁴ Another approach is to require a showing that interested parties have received notice comparable to the disclosure mandated by section 1125 in the context

requirements of § 1125, the voting requirements of § 1126, the best-interests-of-creditors test of § 1129(a)(7), and the absolute priority rule of § 1129(b). *Id.*

¹³¹ In *Lionel* the debtor sought approval of the sale of its most valuable asset, an 82% interest in Dale Electronics, Inc., to a third-party buyer for \$50 million. The sale was supported by the Creditors' Committee, which apparently had been a driving force behind it, and opposed by the Equity Holders' Committee. *Lionel*, 722 F.2d at 1065-66.

¹³² *Id.* at 1070 (emphasis added).

¹³³ *Id.* at 1066. Under the previous bankruptcy laws, courts had been extremely reluctant to approve preconfirmation sales of substantial assets and required as a prerequisite a showing of perishability or other emergency. See, e.g., *In re Pedlow*, 209 F. 841, 842 (2d Cir. 1913) (standard satisfied by sale of handkerchiefs that would lose considerable value unless sold during Christmas season).

¹³⁴ For cases approving sales, see, e.g., *Stephens Indus. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986); *In re Delaware & Hudson Ry. Co.*, 124 B.R. 169, 179 (D. Del. 1991); *In re Engineering Prods. Co.*, 121 B.R. 246, 249 (Bankr. E.D. Wis. 1990); *In re Thomson McKinnon Secs.*, 120 B.R. 301, 309 (Bankr. S.D.N.Y. 1990); *In re Channel One Communications*, 117 B.R. 493, 496 (Bankr. E.D. Mo. 1990); *In re Crowthers McCall Pattern*, 114 B.R. 877, 890 (Bankr. S.D.N.Y. 1990); *In re Oneida Lake Dev.*, 114 B.R. 352, 356 (Bankr. N.D.N.Y. 1990); *In re Naron & Wagner*, 88 B.R. 85, 90 (Bankr. D. Md. 1988). But see *In re George Walsh Chevrolet*, 118 B.R. 99, 102 (Bankr. E.D. Mo. 1990) (denying sale).

Unlike *Braniff* and *Lionel*, none of these cases involved a publicly held firm. Courts may be more willing to approve preconfirmation sales for privately held firms because of a greater likelihood that the firm's assets are completely encumbered.

of a reorganization plan.¹³⁵ Most commentators seem to applaud this treatment of the issue as both sensible and consistent with chapter 11 as a whole. For example, Raymond Nimmer and Richard Feinberg cite *Braniff*, *Lionel*, and their progeny as support for their overall conception of business governance in chapter 11.¹³⁶ According to Nimmer and Feinberg, the debtor in possession enjoys broad decisionmaking discretion in chapter 11 because of its business experience and expertise. They believe, however, that courts should play a much more active (and less deferential) role if the debtor in possession's decision is likely to impose a large adverse impact on one constituency or threatens to dominate the outcome of the entire reorganization. A sale of substantial assets prior to confirmation illustrates the latter concern and thus is a context in which courts should conduct a more searching review than with respect to most other business decisions.¹³⁷

Although the cases and this Nimmer-Feinberg analysis have managed accurately to pinpoint the symptoms, they miss the mark with their cure for the section 363 threat. Consider that outside of bankruptcy, sales of most or all of a firm's assets constitute a fundamental change. Recognizing that managers should not have ultimate authority over fundamental decisions because their decisionmaking incentives are inferior to those of the residual owners of the firm, state corporation statutes require that such sales be submitted to a shareholder vote.¹³⁸ Nimmer, Feinberg, and the cases correctly recognize a similar problem in chapter 11. But the solution cannot be for courts to step in and more closely scrutinize the reasons for proposing the sale. Unfortunately, judges have even worse decisionmaking incentives than managers: because judges have no financial interest in the enterprise and are immune from the market forces that constrain the agency costs of decisionmaking by managers, they are much less suited to play the role of final arbiter with respect to a crucial business decision than to perform traditionally judicial functions, such as policing misbehavior.¹³⁹

¹³⁵ See, e.g., *Naron & Wagner*, 88 B.R. at 88.

¹³⁶ Nimmer & Feinberg, *supra* note 3, at 15-20.

¹³⁷ *Id.* at 19-20.

¹³⁸ E.g., Del. Code Ann. tit. 8, § 271 (1983).

¹³⁹ Baird, *supra* note 2, at 136-37. Kenneth Scott argues that courts are poorly suited to review business judgments made by the firm's managers but well suited to consider alleged

This reasoning suggests that sales of substantial assets should be decided by a vote, rather than by a judge. Because chapter 11 locates the franchise in the plan process, one could argue that such sales should not be permitted prior to the plan's confirmation. Only if the sales are carried out under chapter 11's voting provisions will the affected parties, including the firm's residual owner, have the final say.¹⁴⁰

Proponents of the current regime point out that requiring all asset sales to take place in connection with the plan process ignores the fact that an earlier sale sometimes is in the best interests of everyone, as when the firm's assets could decline in value. Recognizing that in some cases all interested parties will prefer a preconfirmation sale does not mean that enhanced judicial scrutiny under section 363 is the best way to effect such sales, however. Notice that selling the firm's assets prior to confirmation in effect creates a liquidation: it reduces the parties' interests in the firm to interests in a pot of cash.¹⁴¹ Arguably, prohibiting preconfirmation sales in chapter 11 would merely force the parties explicitly to convert the case to chapter 7 and conduct the sale in that context. As long as the decisionmaking appara-

conflicts of interests; accordingly, he concludes that the duty of loyalty should be strengthened and the duty of care eliminated outside of bankruptcy. See Kenneth E. Scott, *Corporation Law and The American Law Institute Corporate Governance Project*, 35 *Stan. L. Rev.* 927, 946 (1983); see also *Shlensky v. Wrigley*, 237 N.E.2d 776, 779 (Ill. App. 1968) ("it is not [the courts'] function to resolve for corporations questions of policy and business management") (citing *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654, 659 (Del. Ch. 1928)); George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law* 65-68 (unpublished manuscript, on file with the Virginia Law Review Association) (discussing courts' ability to deter opportunism). The text makes the same point that within bankruptcy, court involvement should be minimized—not expanded—where a business decision is at issue.

¹⁴⁰ Notice that the parties' right to object to a proposed sale (as provided by the current requirement of notice and a hearing) is not an adequate surrogate for the franchise. Even if we put to one side the limitations of bankruptcy judges as the final arbiter, the right to object is something very different from having the final say. The parties might, for example, vote against a proposal that is sufficiently reasonable to withstand legal objections.

¹⁴¹ A preconfirmation sale inevitably leads to strict adherence to the absolute priority rule because reducing the assets of the firm to cash eliminates any leverage junior creditors and shareholders might otherwise have. Consider the posture of *Lionel* and *Braniff*. See *supra* note 129. One suspects that in *Lionel* the equity holders' opposition to the sale was based on the realization that the sale would eliminate their prospects for recovery. In *Braniff*, the same realization probably caused junior creditors and shareholders (or *Braniff*'s managers, acting on their behalf) to insist that the memorandum of sale include provisions ensuring that their interests would survive confirmation. See *id.*

mus of chapter 7¹⁴² is superior to judicial review of asset sales, such action would improve the current regime.

At least two factors counsel against conversion of cases to chapter 7 from chapter 11 in this context. First, conversion may be costly and contentious. The added expense might chill resort to even clearly desirable early sales. Second, there may be cases in which the parties wish to sell most of the firm's assets but *not* to liquidate (based, perhaps, on their view of the value of the firm's remaining assets).¹⁴³ Prohibiting preconfirmation sales would eliminate this option because firms would be forced to choose between complete liquidation under chapter 7 and forgoing an early sale under chapter 11.

A better solution would permit preconfirmation sales of substantial assets in chapter 11 but transfer authority to a more effective decisionmaker. One way to achieve this goal might be to amend the Bankruptcy Code to compel a vote by all claimants and shareholders prior to approval of any preconfirmation sale of most or all of a firm's assets. Though such universal suffrage seems to make sense from a contractual safeguard perspective, because every constituency is vulnerable in chapter 11,¹⁴⁴ this framework would probably prove unworkable. In contrast to the vote on a reorganization plan, where the deemed acceptances rule tends to focus the voting and where the cramdown provisions provide a means of confirming plans that one or more classes rejects, preconfirmation asset sales would require approval of the appropriate majorities of every class.¹⁴⁵ The necessity of achieving consensus would magnify the risk of strategic behavior and would significantly limit the parties' ability to effect a desirable preconfirmation sale.¹⁴⁶

¹⁴² This is discussed in greater detail *infra* Part III.A.3.

¹⁴³ An example of this might be a large, diversified business that wished to sell its appliances division to help finance the scaling down and reorganization of its core business of processed foods.

¹⁴⁴ See *supra* Part II.B.2.

¹⁴⁵ There is no obvious way to effect a compromise solution. Whereas impaired classes that vote against a reorganization plan are protected (albeit imperfectly) by the absolute priority rule, see Bankruptcy Code § 1129(b)(2), and dissenters must be given at least the liquidation value of their claims, *id.* § 1129(a)(7), the decision whether to approve a sale of substantial assets is an unqualifiable, binary choice.

¹⁴⁶ Another possibility would be for the parties to participate in a single, firm-wide vote rather than a class-based vote. Such a vote could be extremely expensive, however, and would present nearly insoluble problems, such as the question of how to weight the votes of the various claimants and interest holders.

Alternatively, the ultimate decision could be entrusted to the single class of creditors who are identified as the true residual owners of the firm, just as outside of bankruptcy firms give the vote to a single class of common shareholders to reflect their status as residual owners of a solvent firm. Limiting the franchise in this fashion would ensure both a manageable vote and that decisions be made by the constituency with the best decisionmaking incentives. The most obvious difficulty with importing this strategy into the bankruptcy context is determining who the residual owners are. In the unusual case where a firm is solvent when it files for bankruptcy, shareholders are the residual owners; otherwise, the residual owners are those creditors whose priority status leaves them immediately below the insolvency line. The residual ownership class could be identified if the Code were to provide for a valuation of the firm at or shortly after the filing of the chapter 11 petition. But such a valuation would be costly and would consume both physical and temporal resources at a time when both typically are at a premium. Moreover, as the fortunes of a bankrupt firm rise or fall during the course of a chapter 11 case, the firm's residual owner could change.¹⁴⁷ It is thus far from clear when or how the decisionmaking class should be chosen.¹⁴⁸

Finally, the law could designate a particular class as the sole voting class. Adopting a blanket rule would eliminate the need for a costly valuation. Moreover, by defining the voting class relatively broadly, by vesting the vote in unsecured creditors generally, for example, rather than some subcategory of unsecured creditors, the danger of choosing the wrong class as voters, as well as the danger that the residual class could change while the case is pending, could be mini-

¹⁴⁷ The recent chapter 11 case involving Allegheny International is illustrative. Shortly after the firm filed for bankruptcy, an auction developed that at one point would have resulted in payment in full to both senior and unsecured creditors. Thereafter, the auction collapsed and the firm's value began to deteriorate. See, e.g., Clare Ansberry, *When Will Somebody—Anybody—Rescue Battered Allegheny?*, *Wall St. J.*, April 19, 1990, at A1. By the time a plan finally was confirmed nearly two years later, the value of the firm had fallen precipitously.

¹⁴⁸ LoPucki and Whitford cite concerns of this sort as evidence that the residual ownership analysis is ultimately untenable, at least with respect to the related question of to whom management's fiduciary duties should be owed. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Corporations* 92-97 (1991) (unpublished manuscript, on file with the Virginia Law Review Association). The third approach discussed in the text can be seen as a response to these difficulties.

nized.¹⁴⁹ Certainly this approach is imprecise. Allowing every unsecured creditor to vote would mean that the true residual class of unsecured creditors, as well as nonresidual classes of unsecured creditors, would be free to participate in the vote. Notwithstanding its limitations, however, the benefits of a clear rule outweigh the costs of attempting to determine precisely the firm's residual owners. The analysis clearly suggests that it is preferable that a majority of the firm's unsecured creditors, rather than a court, approve any preconfirmation sale of substantial assets.¹⁵⁰

¹⁴⁹ A related question is that of who in the first instance should be entitled to propose a sale of substantial assets—that is, who should have the right of initiation. One might argue that the firm's residual owners should also be given the right to initiate such a proposal, rather than merely the right to vote on proposals presented by management, but such a rule would undermine the managers' ability to run the corporation in chapter 11 and also might invite strategic behavior by the residual class. The current situation, in which management initiates any proposal to sell substantial assets, seems preferable. Notice that this rule mirrors the regime in place under state law. See, e.g., Del. Code Ann. tit. 8, § 271 (1983).

¹⁵⁰ Conducting a vote would require disclosure and give rise to other, related administrative costs. Remember in this regard that the current regime, with its requirement of notice and hearing, see Bankruptcy Code § 363(b)(1), is not costless either. Although providing notice and a hearing is probably less expensive than conducting a vote, the advantages of vesting decisionmaking authority in the residual class, rather than in a bankruptcy judge, would seem to outweigh any differential. Moreover, such votes would not be necessary in every case, only in the relatively infrequent chapter 11 case where management proposes a preconfirmation sale of substantial assets.

Another potential objection stems from the observation that unsecured creditors' decisionmaking incentives are skewed in chapter 11. Although unsecured creditors are likely to be the firm's residual owners, their residual status differs from that of shareholders outside of bankruptcy in that their upside potential is fixed. Whereas shareholders are entitled to the entire residual outside of bankruptcy, in bankruptcy unsecured creditors are entitled to the amount of their claims only, even if the firm's fortunes improve dramatically and the reorganized firm proves to be worth much more than the total of the claims. Based on similar reasoning, LoPucki and Whitford argue that managers should not manage on behalf of either shareholders or creditors alone in chapter 11 because their strategies will be too risky if shareholder-oriented and too risk adverse if creditor-oriented. LoPucki & Whitford, *supra* note 148, at 18, 113-14.

For at least two reasons, these observations do not alter the analysis in the text. First, because firms' fortunes usually will not improve enough in chapter 11 to make full compensation of unsecured creditors a realistic possibility, unsecured creditors' decisionmaking incentives should not be skewed in any significant way. Second, unsecured creditors often receive a significant portion of the equity of the reorganized company. See, e.g., LoPucki & Whitford, *supra* note 84, at 165. As a result, they often *are* the firm's future shareholders, and will therefore share in any postconfirmation upside. In short, the skewing effect seems likely to be more theoretical than real.

2. *A Note on Strategic Choice*

Commentators have noted that the managers of a firm outside of bankruptcy sometimes attempt to ensure passage of a proposal by bundling the proposal with a "sweetener." In the dual class recapitalization context, for instance, managers may promise to increase dividends if the recapitalization is adopted.¹⁵¹ Jeffrey Gordon has used game theory to show that such proposals force shareholders to make a strategic choice: if they wish to receive the (potentially wealth increasing) dividends, shareholders must agree to the (possibly wealth decreasing) recapitalization.¹⁵² The consequence of the shareholders' dilemma, he argues, is that even undesirable recapitalization proposals are likely to pass.¹⁵³

Interestingly, the claimants and interest holders of a chapter 11 debtor may face an analogous strategic choice if a proposal to sell the firm's assets to a third party is coupled with the vote on a reorganization plan. For example, suppose a third party proposes to purchase the firm for \$1 million in connection with a reorganization plan that will pay subordinated bondholders 50% of the face value of their claims. Assume that all parties know the firm's assets actually are worth \$1.2 million. If the subordinated bondholders believed that they would receive only 25% of the value of their claims under a strict absolute priority rule plan and that the best they could hope for under any plan was 30%, the class would be foolish not to approve the proposal. Other classes might be confronted with the same type of dilemma. As such, the parties' desire for the best possible distribution could cause them to approve an inefficient sale.¹⁵⁴

¹⁵¹ See Gordon, *supra* note 11, at 48; Jeffrey M. Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549, 1577-78 (1989).

¹⁵² Gordon, *supra* note 11, at 47-60.

¹⁵³ Insider ownership of significant percentages of the firms' stock and credible threats by management also appear to play a role in shareholders' acceptance of these proposals. *Id.*

¹⁵⁴ Strategic choice issues appear to have played an important role in the collapse of the chapter 11 auction of Allegheny International. See *supra* note 147. During the auction, the debtor twice accepted bids from Donaldson, Lufkin & Jenrette Securities, but was persuaded on both occasions by the other principal bidder, Paul Levy, to reopen the bidding process. It was not at all clear that the Levy bids offered greater value. Instead, the key characteristic of the Levy bids may have been that they promised better treatment for the shareholders of Allegheny. As a result, shareholders (through their committee) put significant pressure on the directors of Allegheny to consider Levy's offers. See Ansberry, *supra* note 147, at A1 (describing the events of the Allegheny case).

The parties may confront a version of this strategic choice dilemma in every chapter 11 case. Even if the reorganization proposal does not involve an explicit sale, in weighing whether to approve a plan each class must compare the amount it might receive under a strict absolute priority rule plan with the amount it would receive under the proposed plan. Because in the absence of an explicit sale there is no obvious way to unbundle the issue of the firm's overall value from the issue of a given class' share, strategic choice is inevitable.¹⁵⁵

But what about cases involving an explicit sale? Requiring that any sale of the firm's assets intact be conducted *separately* from the reorganization plan itself might dramatically reduce the strategic choice problem. In the example, the parties could be required first to sell the firm's assets to the third party and only then to determine the distribution to each class. Because the parties (we have assumed) know the assets are worth \$1.2 million, they presumably would reject the inferior offer if it were unbundled from the question of distribution.

The drawback of such a rule is that it would chill managers' efforts to seek out and propose third-party sales.¹⁵⁶ A preconfirmation sale reduces the firm's assets to a pool of cash, eliminates uncertainty as to the firm's fortunes and the value of its assets (the principal source of bargaining leverage for lower priority claimants and interest holders) and thus ensures strict adherence to the absolute priority rule. Senior creditors would be cashed out first, and junior creditors and shareholders often would receive little or nothing. As a result, managers with interests aligned with those of the junior creditors or shareholders might forgo an otherwise desirable sale.¹⁵⁷

¹⁵⁵ See Douglas Baird & Thomas Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 108 (1984) (arguing that bankruptcy law "should aim to keep the asset-deployment question separate from the distributional question, and to have the deployment question answered as a single owner would answer it"). The strategic choice issue is complicated by plan proponents' use of difficult-to-value debt and equity securities.

¹⁵⁶ See *supra* notes 92-97 and accompanying text for a closely related analysis of whether shareholders should lose their right to vote on a reorganization plan even if the firm is clearly insolvent.

¹⁵⁷ See LoPucki & Whitford, *supra* note 148 (concluding that managers of publicly held firms were sometimes shareholder-oriented in chapter 11, and sometimes creditor-oriented). For similar reasons, managers may also be hesitant to propose preconfirmation asset sales under current law. Unless the firm is hopelessly insolvent (and the lower classes thus unlikely to receive any distribution under any plan), the proposal somehow also guarantees a recovery for junior creditors and shareholders, or the managers' interests are, for some other reason, no

3. *The Analogy to Creditors' Election of the Chapter 7 Trustee*

My proposal to put preconfirmation sales of substantial assets to a vote by the unsecured creditors already has been adopted (at least in part) in chapter 7 liquidation cases. In particular, section 702 designates unsecured creditors as the voting class, with the right to select the trustee by a majority vote (in amount) of the unsecured creditors who vote, if the holders of twenty percent in amount of these claims have requested such an election.¹⁵⁸ Otherwise, the interim trustee continues to serve as trustee.¹⁵⁹ Of course, this mechanism is less direct than my proposal to permit unsecured creditors to decide whether to approve a preconfirmation sale of substantial assets. But the unsecured creditors' more limited role in chapter 7 is easily explained. Chapter 7 usually consists of a piecemeal liquidation of the firm;¹⁶⁰ rather than selling the firm as a going concern, the trustee conducts a series of partial sales. Educating the unsecured creditors as to the merits of each of these partial sales, and submitting each to a vote no matter how trivial the sale, would be as unwieldy as providing for shareholders of a publicly held corporation to oversee the ordinary operations of the firm. Just as shareholders elect directors (who in turn appoint officers) to be their representatives with respect to the firm's ordinary affairs and vote directly on fundamental issues only, so unsecured creditors, the firm's residual owners in bankruptcy, leave the day-to-day business of a chapter 7 liquidation to their chosen representative, the trustee.

But what if the trustee in a given case does not intend a piecemeal liquidation of the firm? What if she proposes a third-party sale? This possibility brings the discussion full circle. The analysis of preconfirmation sales of substantial assets in the chapter 11 context would be in such a situation equally applicable in chapter 7. Thus, the trustee's proposal to effect a third-party sale in chapter 7 can be seen as a fundamental issue that should be put to a vote of the unsecured creditors,

longer aligned with those of the shareholders or lower priority creditors, managers are unlikely to propose preconfirmation sales.

¹⁵⁸ Bankruptcy Code § 702(b).

¹⁵⁹ *Id.* § 702(d).

¹⁶⁰ Baird, *supra* note 2, at 131, 146-47. Baird explains the rarity of sales of firms intact in chapter 7 as resulting from the nature of the chapter 7 trustee's powers, which are designed with piecemeal liquidation in mind, and from the sacrifice of certain tax benefits if a firm liquidates in chapter 7. See LoPucki & Whitford, *supra* note 84, at 171 n.104.

as should a preconfirmation sale of substantial assets in chapter 11; likewise, a proposal by the directors to sell most or all of a firm's assets would trigger shareholders' voting rights outside of bankruptcy.

B. Shareholders' Right to Compel a Shareholders' Meeting

1. Judicial and Academic Treatment of Shareholders' Meeting Requests

Given the dramatic increase in chapter 11 cases involving publicly held firms,¹⁶¹ the most important of the chapter 11 voting issues may be shareholders' right to compel a shareholders' meeting. In the last several years alone, the issue has arisen in three major bankruptcy cases.

In *Saxon Industries v. NKFV Partners*,¹⁶² the Delaware Supreme Court, reasoning that shareholders are entitled to elect and replace directors absent extraordinary circumstances, held that Saxon's shareholders should be able to compel a shareholders' meeting.¹⁶³ Shareholders were equally successful in vindicating their claimed right to compel a shareholders' meeting in *In re Lionel*.¹⁶⁴

In *In re Johns-Manville Corp.*,¹⁶⁵ on the other hand, both the bankruptcy court and the district court rejected the Equity Committee's efforts to compel a shareholders' meeting, each court voicing concern that a shareholders' meeting would jeopardize a reorganization proposal that had been three years in the making. The United States Court of Appeals for the Second Circuit reversed because it was not clear whether the district court had denied the meeting as a result of

¹⁶¹ Sharon Reier, Bankruptcy Boondoggle, *Fin. World*, Oct. 16, 1990, at 36 (noting that 13 of the 25 largest bankruptcies have occurred in the last two years).

¹⁶² 488 A.2d 1298 (Del. 1984).

¹⁶³ *Id.* at 1301-03.

¹⁶⁴ *Lionel Corp. v. Committee of Equity Sec. Holders of Lionel Corp. (In re Lionel Corp.)*, 30 B.R. 327, 330 (Bankr. S.D.N.Y. 1983). In allowing the Equity Committee to pursue its meeting request in the Delaware chancery court, the bankruptcy judge stated that "if the defendants 'are able to elect a new board it may be that the reorganization here will take an entirely different turn.'" *Id.* (remarking upon the court's observation at an earlier hearing of the case). The chancery court ordered Lionel's directors to call the requested meeting. *Committee of Equity Sec. Holders of the Lionel Corp. v. Lionel Corp.*, N.Y.L.J., June 28, 1983, at 6 (N.Y. Sup. Ct. 1983).

¹⁶⁵ 52 B.R. 879 (Bankr. S.D.N.Y.), *aff'd*, 60 B.R. 842, 852 (S.D.N.Y.), *rev'd*, 801 F.2d 60 (2d Cir. 1986).

the Equity Committee's use of the request as a strategic tool, or because the judge had determined that the committee wished to "torpedo" the reorganization.¹⁶⁶ The latter situation warrants denial of the request, the court held, but the former does not, as shareholders have the right to a meeting absent a showing the meeting would constitute a "clear abuse" and would cause "irreparable harm" to the corporation.¹⁶⁷ On remand, the bankruptcy court compiled an exhaustive record in support of its original determination and again enjoined the Equity Committee from seeking a meeting.¹⁶⁸

These cases suggest that courts continue, in bankruptcy, to recognize shareholders' state law right to hold a meeting.¹⁶⁹ Nonetheless, courts will interfere with shareholders' efforts to replace and elect directors if, as appears to have been the case in *Johns-Manville*, the shareholders clearly have overstepped their bounds.¹⁷⁰ Most commentators have agreed that bankruptcy does not and should not affect shareholders' right to hold a shareholders' meeting to replace or elect directors.¹⁷¹ For example, Michael Gerber's thoughtful commentary

¹⁶⁶ *Johns-Manville*, 801 F.2d at 64-68.

¹⁶⁷ *Id.*

¹⁶⁸ *In re Johns-Manville Corp.*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986).

¹⁶⁹ Less than two years after the *Johns-Manville* decisions, the United States District Court for the Western District of Pennsylvania decided a fourth shareholders' meeting request case in favor of a group of preferred shareholders who sought to make use of the voting rights they had acquired when Allegheny International stopped paying dividends prior to bankruptcy. Following their victory, the preferred shareholders conducted a proxy contest and, at the subsequent meeting, placed five directors on the twelve-person board. *In re Allegheny Int'l* [1987-1989 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 72,328 (W.D. Pa. May 31, 1988).

Pre-Code decisions permitting or compelling shareholders' meetings include *Harvey v. Plankinton Bldg. Co.*, 138 F.2d 221 (7th Cir. 1943); *In re J.P. Linahan, Inc.*, 111 F.2d 590 (2d Cir. 1940); *Van Siclen v. Bush*, 78 F.2d 662 (2d Cir. 1935); *Taylor v. Philadelphia & Reading R.R.*, 7 F. 381 (E.D. Pa. 1881). But see *Fortgang & Mayer*, *supra* note 99, at 65-68 (arguing that shareholders' meetings were permitted in pre-Code cases only where holding a meeting would have had no effect at all on the reorganization).

¹⁷⁰ Pre-Code cases denying meeting requests include *In re Potter Instrument Co.*, 593 F.2d 470, 474 (2d Cir. 1979) (denying meeting sought by large shareholder bent on "smash[ing]" the company); *Haugh v. Industries, Inc.*, 141 F.2d 425 (2d Cir. 1944) (affirming stay of meeting pending resolution of a Chapter X case that was likely to be dismissed); *Graselli Chem. Co. v. Aetna Explosives Co.*, 252 F. 456 (2d Cir. 1918) (denying preferred shareholders' request for a meeting where preferred shareholders' voting rights arose only after the appointment of a receiver and were likely to be temporary); *Alrac Corp. v. Clement*, 1 Bankr. Ct. Dec. (CRR) 1504 (Bankr. D. Conn. 1975) (denying meeting where request came after confirmation of a reorganization plan that would give majority control to current creditors).

¹⁷¹ An article co-authored by Chaim Fortgang and Thomas Mayer is a conspicuous exception. *Fortgang & Mayer*, *supra* note 99. Fortgang and Mayer read both the Bankruptcy

on *John-Manville* notes that shareholders' right to call a meeting is an important bargaining chip for shareholders in bankruptcy.¹⁷² He argues that their retention of this privilege is consistent both with the Bankruptcy policy of incorporating state law in the absence of indications to the contrary, and with the drafters' attempt to encourage consensual reorganization plans.¹⁷³ Mark Budnitz has recently echoed these concerns.¹⁷⁴ He argues that the federal proxy rules support shareholders' retention in chapter 11 of their state law right to elect and replace directors because their principal concern is investor protection.¹⁷⁵ On the other hand, he recognizes that the drafters of the Bankruptcy Code expressed a desire not only to protect investors, but also to promote speedy reorganization.¹⁷⁶ To reconcile these concerns, Budnitz proposes an elaborate balancing test that presumes in most cases shareholders should be entitled to elect and replace directors as they wish.¹⁷⁷

Neither the case law nor the commentary, however, provides a persuasive response to the question of why shareholders should retain the right to hold a meeting if the corporation is insolvent, as most chapter 11 debtors are.¹⁷⁸ Both courts and commentators suggest that share-

Code and pre-Code case law as precluding shareholders from calling a shareholders' meeting in the chapter 11 context.

¹⁷² Michael A. Gerber, *The Election of Directors and Chapter 11—The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 Brooklyn L. Rev. 295 (1987).

¹⁷³ *Id.*

¹⁷⁴ 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 (1990); see also Anna Y. Chou, *Corporate Governance in Chapter 11: Electing a New Board*, 65 Am. Bankr. L.J. 559 (1991) (Congress intended chapter 11 to salvage value for shareholders and did not intend to deprive shareholders of insolvent firms of the right to elect directors).

¹⁷⁵ Budnitz, *supra* note 174, at 1225-27.

¹⁷⁶ *Id.* at 1233-34.

¹⁷⁷ *Id.* at 1255-66. Budnitz suggests that courts should compare the benefits of holding a meeting with what he describes as "major harms" and "minor harms." Major harms include concerns such as the stage of the case, abuse of the shareholder-director relationship, and cost (where the debtor is seriously low on funds). Minor harms include the threat and consequences of delay, and the availability of alternatives to a shareholders' meeting. In his view, minor harms are insufficient, by themselves, to warrant denial of a meeting request.

¹⁷⁸ Unlike Budnitz, Gerber does not suggest that the firm's insolvency should never be a factor. Rather, he acknowledges that "[t]here will be cases in which a debtor is so obviously . . . insolvent that experts can agree that stockholders have no equity . . . and no prospect of ever having any," and that meeting requests should be denied in such a context. Gerber, *supra* note 172, at 354; cf. Budnitz, *supra* note 174, at 1248-49 (directors of an insolvent firm have a continuing fiduciary duty to shareholders).

holders need this privilege as leverage in the negotiation process, regardless of whether the firm is insolvent; this is costly, however, especially considering that the shareholders' interest is much more attenuated in an insolvent firm.¹⁷⁹

One cost is that shareholders may (and do) call shareholders' meetings opportunistically. Consider the effect of shareholders' status in bankruptcy. Because chapter 11 debtors usually are insolvent, an immediate liquidation would leave shareholders with nothing. Moreover, shareholders may not expect to receive much even if the firm is reorganized.¹⁸⁰ Thus, shareholders have little to lose when they invoke their right to call a meeting and are unlikely to be constrained by the possibility that their use of this tactic as a bargaining tool could jeopardize the entire reorganization.

Several of the decided cases support these suspicions. The Equity Committee in *Johns-Manville* requested a meeting for the avowed purpose of imploding the current reorganization plan.¹⁸¹ The Committee's willingness to unsettle the negotiations, even at the risk of jeopardizing any prospect of eventual reorganization, appears to have stemmed directly from the probability that shareholders' interests would have been significantly diluted under that or any other plan. Similarly, in *In re Potter Instrument Co.*,¹⁸² a 45% shareholder sought to compel a shareholders' meeting for the purpose of electing directors who would contest a chapter 11 arrangement that had been approved by creditors, notwithstanding that such a meeting might sound the "death knell" to the debtor firm.¹⁸³

The "clear abuse" test relied on by the courts is an insufficient response to this problem because shareholders' incentives are systematically, not just occasionally, flawed. Moreover, any directors

¹⁷⁹ In addition to arguing from a positive perspective that shareholders' continued right to call a meeting, despite insolvency, is consistent with chapter 11's relaxation of the absolute priority rule, Gerber suggests that permitting shareholders to retain this bargaining tool is unproblematic because it merely effects a redistribution from higher priority creditors to shareholders, without affecting the size of the overall pie. Gerber, *supra* note 172, at 343. Baird and Jackson, on the other hand, have argued that redistribution in bankruptcy by its very nature ultimately may reduce the size of the pie. See, e.g., Baird & Jackson, *supra* note 155; Jackson, *Creditors' Bargain*, *supra* note 2, at 360-71.

¹⁸⁰ See Jackson & Scott, *supra* note 89, at 158-59.

¹⁸¹ *Johns-Manville*, 60 B.R. at 852.

¹⁸² 593 F.2d 470 (2d Cir. 1979).

¹⁸³ *Id.* at 474-75.

elected by shareholders also will have suspect decisionmaking incentives. Thus, the effect of permitting a shareholders' meeting would be to put decisionmaking authority in the hands of directors who do not represent the best interests of the corporation as a whole.

The conclusion that directors selected by shareholders will share the constituency's poor decisionmaking incentives may seem subject to dispute. Arguably, even directors elected by the shareholders will be constrained in that once a firm enters bankruptcy, directors owe fiduciary duties to creditors as well as to shareholders. In theory, then, directors cannot simply side with shareholders if shareholders' interests conflict with those of creditors and of the firm as a whole.¹⁸⁴ But this response is hardly satisfactory. First, it has not been empirically shown that directors who are chosen and elected by shareholders will truly embrace the interests of the estate as a whole once they have taken office.¹⁸⁵ One suspects, to the contrary, that such directors will continue to represent shareholders' interests, although the fervency of this favoritism may be limited at the margin by recognition of their duties to creditors and the estate.¹⁸⁶

Second, even if directors elected by shareholders were capable of putting their loyalty to one side, it seems ironic that shareholders, a constituency whose decisionmaking incentives almost always will conflict with the goal of maximizing the value of the firm, are given the right to choose the debtor's directors. In short, if one single constituency should be entitled to call a meeting in chapter 11 to replace the firm's directors, shareholders seem an unlikely choice.

Even the most persuasive of the arguments marshaled on behalf of granting shareholders' meeting requests proves problematic on closer inspection. As noted, both courts and commentators place heavy

¹⁸⁴ See, e.g., Budnitz, *supra* note 174, at 1248-49.

¹⁸⁵ The chapter 11 experience of Allegheny International reinforces the suspicion that they will not. The five directors who were elected by the preferred shareholders in that case were perceived by the parties to be advocates, first and foremost, of the preferred shareholders who elected them, notwithstanding the directors' duties to creditors and the estate as a whole. The identification was so strong that these directors were often referred to as the "Spear Leeds directors" (Spear, Leeds & Kellogg being the preferred shareholder most responsible for their election). See Ansberry, *supra* note 147, at A8.

¹⁸⁶ LoPucki and Whitford conclude that management's allegiances are uncertain in chapter 11. See LoPucki & Whitford, *supra* note 148, at 81-84. However, none of the cases in their study appears to have involved the replacement of directors *during* bankruptcy with new directors elected by the debtor's shareholders. It seems likely that, as in *Allegheny*, such directors would (at least nominally) be beholden to the constituency that elected them.

emphasis on the fact that shareholders' right to elect directors is an important safeguard outside of bankruptcy. Taking away this prerogative, they argue, removes one of few mechanisms by which shareholders are able to minimize the threat of opportunism by the firm.¹⁸⁷ But shareholders are not the only exposed parties. Recall that the firm's other constituencies must also relinquish their contractual safeguards in chapter 11.¹⁸⁸ Thus, removal of shareholders' right to compel a shareholders' meeting can be seen, in context, as consistent with the pervasive restructuring of other parties' contractual safeguards that takes place in chapter 11.

2. *Who Should the Voters Be and When Should Elections Be Held?*

If shareholders should not be permitted to compel a meeting, who should hold this right? Again there are two possible answers: either all constituents or the true residual owners of the firm.

As in the discussion of asset sales, focusing on contractual safeguards might point toward the choice of a universal franchise: because each constituency is exposed in bankruptcy, arguably each should have a voice in governance.¹⁸⁹ Universal suffrage in the asset sale context is administratively infeasible because such a system would require the approval of every class for a sale of assets. Interestingly, universal franchise seems, at first, to hold more promise in connection with the election of directors. In particular, the Bankruptcy Code could eliminate the necessity for unanimous approval, or for weighting each claimant or interest holder's vote, by permitting each constituency to elect a preascertained number (or percentage) of directors.¹⁹⁰

This approach succeeds in giving each constituency representation, and thus a voice, on the board, but it suffers from significant shortcomings. Not only would the representation of each constituency be

¹⁸⁷ Budnitz, *supra* note 174, at 1248-50; Gerber, *supra* note 172, at 341-48; Mark A. Cleaves, Comment, Stockholders' Rights in a Corporate Democracy Under Delaware Corporation Law During Bankruptcy: *Saxon Industries, Inc. v. NKFV Partners*, 11 Del. J. Corp. L. 821 (1986).

¹⁸⁸ See *supra* notes 76-87.

¹⁸⁹ See *supra* notes 144-46 and accompanying text.

¹⁹⁰ Cf. Del Code Ann. tit. 8, § 141(d) (1983) (authorizing firms to provide for a classified board outside of bankruptcy).

diluted by the presence of directors beholden to other classes of claimants, but the directors' efforts to serve their respective constituencies would make decisionmaking consensus virtually impossible.¹⁹¹

Thus, though universal suffrage offers more intriguing possibilities in the context of a directorial election than it did with respect to sales of substantial assets, limiting the franchise to the firm's true residual owners—presumably its unsecured creditors—emerges once again as the better choice. As before, the chief virtue of such a rule is its effect on decisionmaking incentives. The rule also avoids the kinds of administrative difficulties that make universal suffrage largely unworkable in the absence of a focusing device like the deemed acceptances rule.¹⁹²

Selecting unsecured creditors as the appropriate voters still leaves the question of when elections should be held. Consider first the possibility that directors elected by shareholders might continue to favor shareholders' interests after the firm filed for chapter 11 relief, notwithstanding that these interests would be then merely speculative. One could plausibly argue, based on this perception, that the firm's directors should be replaced, or at the least an election held, at the commencement of every chapter 11 case in order to ensure that directors have proper decisionmaking incentives.¹⁹³

But holding an election and replacing the firm's directors at the start of every bankruptcy would be both cumbersome and expensive. One reason the Bankruptcy Code permits current management to remain in place as the debtor in possession, with virtually the same rights as a trustee,¹⁹⁴ is to minimize disruption to the firm's ongoing business. Moreover, if current managers feared that new directors

¹⁹¹ Martin Lipton and Steven Rosenblum make a somewhat similar point in arguing that, outside of bankruptcy, directors should represent all corporate constituencies rather than just shareholders, but that "[i]t is not necessary, and indeed it would be divisive, to elect separate classes or groups of directors to represent the various corporate constituencies, or to have any constituency have a separate special right to nominate or advise on the nomination of directors." See Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187, 247 (1991).

¹⁹² See *supra* note 66 and accompanying text.

¹⁹³ Such a rule would be similar in many respects to the contractual provisions that give voting rights to lenders or preferred stockholders if the firm defaults on an obligation or considers a particularly risky undertaking. The notion in both cases is that default or a bankruptcy petition is likely to reflect a change in risks such that shareholders no longer are the appropriate decisionmakers for the firm. See Easterbrook & Fischel, *supra* note 6, at 404.

¹⁹⁴ Bankruptcy Code § 1107.

might immediately replace them, notwithstanding the business continuity contemplated by the drafters of the Bankruptcy Code, they would have a perverse incentive to delay entering chapter 11.¹⁹⁵ As a result, wholesale turnover at the start of the bankruptcy case is an unattractive option.¹⁹⁶

The same concerns also suggest that the firm's residual owners should not have an automatic right to compel a meeting. The Bankruptcy Code should provide some opportunity for the replacement of directors, however, because at times mismanagement or stalemate will make an election desirable.

One possibility that could effectively balance these concerns would be to adopt the "for cause" standard, used elsewhere in the Bankruptcy Code to justify replacement of management with a trustee.¹⁹⁷ The "for cause" requirement would establish a rebuttable presumption that the current directors should remain in place for the duration of the bankruptcy case.¹⁹⁸ Because replacement of directors is a less draconian measure than appointment of a trustee, courts should and presumably would require a lesser showing of "cause" in the former context than they currently do in the latter.¹⁹⁹ Such a rule would ensure continuity, while still providing an alternative to appointing a trustee on those occasions when the firm's management is in fact

¹⁹⁵ Even if their jobs were secure, managers would lose the advantage of the prebankruptcy working relationship they are likely to have established with the current directors.

¹⁹⁶ The directors themselves often do not wish to retain their positions, however, due to the significant increase in board meetings and other responsibilities that typically accompanies a chapter 11 petition. One response to this problem would be, and should be, to increase directors' compensation in bankruptcy. See, e.g., Lipton & Rosenblum, *supra* note 191, at 227 (making a similar suggestion in connection with their proposal that directors be elected on a quinquennial basis). Another possibility would be to attempt to tie the directors' compensation to the success of the reorganization. In the event that directors do resign, the remaining directors themselves should fill the vacancies, as the laws of many states permit them to do outside of bankruptcy. E.g., Del. Code Ann. tit. 8, § 223 (1983).

¹⁹⁷ Bankruptcy Code § 1104(a)(1). Section 1104(a)(2) also authorizes appointment of a trustee "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."

¹⁹⁸ Court discretion is less problematic here than in the context of preconfirmation sales of substantial assets because the court is deciding only whether there will be a vote. The actual choice of directors would be made by the firm's unsecured creditors, not the court.

¹⁹⁹ See *In re Microwave Prods. of Am.*, 102 B.R. 661, 670 (Bankr. W.D. Tenn. 1989) ("appointment of a trustee is the exception"); *In re Tyler*, 18 B.R. 574, 577 (Bankr. S.D. Fla. 1982) ("appointment of a trustee . . . is an extraordinary remedy").

impeding the reorganization effort or the directors are stalemated or otherwise serving ineffectively.

C. *Buying a Blocking Position Within a Class of Claims*

Recall from the discussion in Part II.D. that section 1126 requires, for acceptance by a class of claims, that a majority in number and two-thirds in amount of the claims vote in favor of the proposed reorganization plan and that this standard tends to operate like a two-thirds supermajority voting requirement.²⁰⁰

A two-thirds voting requirement gives any claimant who acquires claims totaling just over one-third in amount veto power over the vote of the class in question. Courts already have begun to struggle with the question of what limitations (if any) should be imposed on parties' exercise of this veto power.²⁰¹ The dramatic increase in the trading of bankruptcy claims²⁰² suggests that the issue will play a crucial role in future bankruptcies.

1. *Assertion of Veto Power in Allegheny International*

The scope of the veto power was a central issue in *In re Allegheny International, Inc.*²⁰³ In January, 1990, nearly two years after Alle-

²⁰⁰ See *supra* note 99 and accompanying text.

²⁰¹ See *infra* notes 208-09.

²⁰² See, e.g., Diana B. Henriques, Speculating on Bankruptcies, N.Y. Times, Oct. 21, 1990, § 3, at 15; Stephen Taub, Attention Vulture Shoppers, Fin. World, March 6, 1990, at 16. Despite the apparent virtues of claims trading, such as increased liquidity and the likelihood that the purchasers of claims will take an active interest in the bankruptcy case, Fortgang & Mayer, *supra* note 99, at 4-6, courts have viewed the phenomenon with considerable suspicion. The courts' principal concern is that claims traders will take advantage of claimants who may be poorly informed about their prospects for recovery. To prevent this result, several bankruptcy courts have devised their own safeguards. See, e.g., *In re Allegheny Int'l*, 100 B.R. 241, 243-44 (Bankr. W.D. Pa. 1988) (sellers must be given current estimates of the value of their claims and the right to rescind); *In re Revere Copper and Brass*, 58 B.R. 1 (Bankr. S.D.N.Y. 1985) (requiring that sellers of claims be given 30 days to rescind the sale where buyers failed adequately to inform sellers of their options). One court even denied a transfer altogether, where the buyer failed to disclose its intention to propose a 100% plan, though Bankruptcy Rule 3001(e), which governs transfers, treats the court's role as largely ministerial. *In re Chateaugay (In re LTV Energy Prods.)*, Ch. 11 Case Nos. 86B-112270/334, 402, 464 (Bankr. S.D.N.Y. Mar. 11, 1988). The newly revised version of Bankruptcy Rule 3001(e) eliminates such ad hoc measures by giving the transferor 20 days to reconsider the transfer, after which time the court must substitute the transferee for the transferor in its records. Notice that neither the old nor the new version of Bankruptcy Rule 3001(e) governs transfers of publicly traded bonds.

²⁰³ 118 B.R. 282 (Bankr. W.D. Pa. 1990).

gheny filed its bankruptcy petition and a year after an auction for the company had collapsed, the bankruptcy court approved a disclosure statement submitted by Allegheny, thus paving the way for a vote on the debtor's plan.²⁰⁴ Also in January, 1990, Japonica Partners filed a competing plan pursuant to which Japonica would take control of the reorganized company. In an effort to ensure defeat of the debtor's plan, and to better the prospects of confirming its own plan, Japonica purchased claims sufficient to give it a blocking position in two classes, the class of secured bank lenders and the senior class of unsecured claims.²⁰⁵ When Japonica caused these classes to vote against the debtor's plan, thus precluding confirmation, Allegheny asked the bankruptcy court to disqualify Japonica's votes and to confirm the plan.

The bankruptcy court opinion in *Allegheny* points out that section 1126(e) specifically authorizes a court to "'designate' (i.e., disqualify) the ballot of 'any entity whose acceptance or rejection . . . was not in good faith, or was not solicited or procured in good faith.'"²⁰⁶ Thus, a blocking creditor must wield her influence in good faith. The line between good and bad faith is not always clear, however. A creditor's votes should not be disqualified merely because she purchased claims (as Japonica did in *Allegheny*) for the purpose of defeating a reorganization plan. But a determination that a creditor's intent is unrelated to her status as a creditor of the class in question may warrant designation.²⁰⁷ Accordingly, a creditor can reject a reorganization plan if she expects that a subsequent plan will provide greater value,²⁰⁸ but not because she runs a competing business and wishes to see the debtor eliminated.²⁰⁹

²⁰⁴ Id. at 286.

²⁰⁵ Japonica purchased a total of 33.87% of the secured bank claims. With respect to the senior unsecured claims, Japonica purchased slightly less than the 33% technically necessary to establish veto power over the class, but because many of the claimants in this class were not expected to vote, and in fact did not, Japonica held an effective veto in this class as well. Id. at 286-87.

²⁰⁶ Id. at 287 (quoting Bankruptcy Code § 1126(e)).

²⁰⁷ Id. at 289 (citing *In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945)).

²⁰⁸ See, e.g., *Insinger Mach. Co. v. Federal Support Co.*, 859 F.2d 17 (4th Cir. 1988); *Mokava Corp. v. Dolan*, 147 F.2d 340 (2d Cir. 1945); *In re Pine Hill Collieries Co.*, 46 F. Supp. 669 (E.D. Pa. 1942); *In re Gilbert*, 104 B.R. 206 (Bankr. W.D. Mo. 1989); *In re Landau Boat Co.*, 8 B.R. 432 (Bankr. W.D. Mo. 1981).

²⁰⁹ See *In re MacLeod Co.*, 63 B.R. 654 (Bankr. S.D. Ohio 1986) (designating votes of three creditors employed by debtor's competitor); see also *In re P-R Holding Corp.*, 147 F.2d 895

The court in *Allegheny* concluded that Japonica's motives fell into the latter category. Because Japonica appeared to have bought its claims for the purpose of asserting control over the debtor and the reorganization process, rather than to further any interest sufficiently related to its status as a member of the two classes of claims, the court disqualified Japonica's votes and, subject to several restrictions, confirmed the *Allegheny* plan.²¹⁰

As *Allegheny* suggests, section 1126(e) operates as an impressionistic (i.e., left to the court's discretion) limitation on parties' exercise of their voting rights. Although courts appear to apply the standard in a principled fashion,²¹¹ the need for judicial oversight²¹² could be significantly reduced by changing chapter 11's voting rules.

2. *The Need to Replace the Supermajority Voting Requirement With Simple Majority Voting*

Recall from Part II.D. the problem with the supermajority voting requirement set forth in section 1126. Supermajority voting is useful only where, as in a close corporation, there is a danger that corporate decisions will by their very nature affect majority and minority shareholders differently. This is not the case in voting on a reorganization plan, where each member of the class will receive a proportionate distribution.²¹³ Thus, replacing the two-thirds in amount standard with

(2d Cir. 1945) (bad faith established where purchase of claims resulted in discrimination against creditors who did not sell their claims); *In re Featherworks Corp.*, 36 B.R. 460 (E.D.N.Y. 1984) (bad faith found where party changed vote after being paid outside of the reorganization plan).

²¹⁰ *In re Allegheny*, 118 B.R. at 285.

²¹¹ According to one commentator, the case law reveals two different approaches to the issue of good faith. Some courts, based on the Supreme Court's decision in *Young v. Higbee Co.*, 324 U.S. 204 (1945), ask whether the creditor in question is seeking better treatment than that received by the other members of her class; other courts, based on *In re P-R Holding Co.*, 147 F.2d at 897, find bad faith whenever a creditor is using her vote to advance "an interest other than an interest as a creditor." See Andrew Africk, Comment, Trading Claims in Chapter 11: How Much Influence Can be Purchased in Good Faith Under Section 1126?, 139 U. Pa. L. Rev. 1393, 1406-08, 1416-22 (1991) (concluding that good faith should be presumed because blocking creditors play a desirable role in most chapter 11 cases).

²¹² Again, judicial discretion is much less problematic here than in the context of sales of substantial assets because courts are not called upon to make business decisions. Instead, they scrutinize for misbehavior, a task more in line with their competence. Cf. *supra* note 139 and accompanying text (management, not courts, should make business decisions).

²¹³ See also Brudney & Chirelstein, *supra* note 108, at 1357 (simple majority voting is appropriate in arm's-length merger decisions where all stockholders will be treated alike);

a majority requirement would sacrifice little in terms of claimant protection. Moreover, eliminating the supermajority requirement would diminish in two related ways the threat of hold-up by blocking creditors. First, the majority voting requirement would significantly increase the cost of acquiring a blocking position by necessitating the purchase of more than one-half in amount of the class. Second, a party that buys more than fifty percent of the claims in a class seems at least marginally less likely to put its investment at risk by wielding its veto in a fashion inconsistent with the best interests of the class.²¹⁴

In the close corporation context, fiduciary duty standards strike a balance between minority protection and the risk of strategic behavior. In *Smith v. Atlantic Properties, Inc.*,²¹⁵ for instance, the court held that a minority shareholder who continually vetoed the dividend proposals made by his fellow shareholders had violated his fiduciary duty to the firm and the other shareholders.²¹⁶ Section 1126(e) performs precisely the same function—it serves as a fiduciary duty limitation on blocking creditors' use of their veto power.

My analysis suggests, however, that supermajority voting is both unnecessary and undesirable in chapter 11. This raises the question whether replacing the supermajority standard with simple majority voting so reduces the threat of harmful behavior by blocking creditors as to obviate the need for the fiduciary duty requirement now in section 1126(e).

Because a change in the voting rules would reduce, but not eliminate, the likelihood of strategic behavior, section 1126(e) clearly should be retained. The fiduciary standard that courts apply to par-

Milton Harris & Arthur Raviv, Corporate Governance: Voting Rights and Majority Rules, 20 J. Fin. Econ. 203 (1988) (deriving formal conditions under which simple majority voting is the socially optimal corporate governance rule).

²¹⁴ The concern that claimants act in the best interest of their class should not be confused with a concern for the best interests of the firm as a whole. A claimant acting in the best interests of her class may well urge actions that, from the firm's perspective, are suboptimal. See Baird & Jackson, *supra* note 155, at 106. The problem with a claimant who uses her vote strategically is that exercising the franchise in that fashion is likely to be inconsistent with the interests both of the class and of the firm as a whole.

²¹⁵ 422 N.E.2d 798 (Mass. App. Ct. 1981).

²¹⁶ *Id.* at 800. The shareholder apparently favored reinvestment of earnings, rather than dividends, because of the tax consequences to him of dividends. The remaining shareholders sued when he refused to withdraw his opposition even after the Internal Revenue Service threatened to, and then actually did, take action against the firm for unlawful accumulation of earnings.

ent-subsidary relationships outside of bankruptcy provides a useful analogue in this respect. In the parent-subsidary context, courts recognize that, because a parent is the principal shareholder of the subsidiary, its interests usually are aligned with those of the subsidiary.²¹⁷ Accordingly, courts apply the relaxed business judgment rule standard to most decisions made by the parent as controlling shareholder. Only when the parent "causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary" do courts apply the more searching intrinsic fairness standard.²¹⁸

Similarly, there is no need to disqualify a blocking creditor's votes unless there is evidence that the creditor expects to receive something that the remaining members will not receive. *Aladdin Hotel Co. v. Bloom*²¹⁹ is a classic example of such a situation. In *Aladdin Hotel*, shareholders bought a controlling position with respect to a class of debentures for the sole purpose of coercing an amendment to the debenture indenture favorable to their interests as shareholders but not to the remaining debenture holders. Thus, searching scrutiny of the shareholders' use of their debenture votes was needed, although not given by the court.²²⁰

A final issue to consider is the efficacy of the section 1126(e) remedy. Because the remedy—disqualification of a claimant's vote—is injunctive in nature and does not contemplate payment of monetary damages by a controlling creditor who has breached her fiduciary duty, section 1126(e) may prove an insufficient deterrent. On the other hand, disqualification enables a court immediately to undo the damage caused by the controlling creditor. Thus, a court can disqualify votes in an appropriate case and go on to confirm the reorganization plan in question in the same hearing (if it otherwise would have passed). The bankruptcy judge can also invoke her equitable powers to augment the remedy if necessary.²²¹ Because the equitable remedies available to the court—equitable subordination,²²² for instance—

²¹⁷ See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

²¹⁸ *Id.* at 720.

²¹⁹ 200 F.2d 627 (8th Cir. 1953).

²²⁰ The legislative history of § 1126(e) condemns the result in *Aladdin* and suggests that its facts reflect the sort of manipulation that § 1126(e) was designed to prevent. House Report, *supra* note 61, at 411; Fortgang & Mayer, *supra* note 99, at 93 n.442.

²²¹ Bankruptcy Code § 105.

²²² See *id.* § 510(c).

have precisely the same effect as an award of monetary damages, the remedies available in connection with section 1126(e) should fully serve their intended function.

To summarize, amending section 1126 of the Bankruptcy Code to provide for simple majority rather than supermajority voting might diminish the threat of creditors' acquiring a blocking position and wielding their influence improperly. The fiduciary duty standard codified in section 1126(e) should be retained, but need be applied only if there is evidence that the blocking creditors' votes are a function of an interest at odds with that of the remaining members of the class.²²³

²²³ Two recent articles have continued the discourse with respect to this issue. Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 *Cardozo L. Rev.* 1 (1991); Herbert P. Minkel, Jr. & Cynthia A. Baker, *Claims and Control in Chapter 11 Cases: A Call for Neutrality*, 13 *Cardozo L. Rev.* 35 (1991).

One final chapter 11 voting issue also should be mentioned: debtors' efforts to "lock-up" the votes on a reorganization plan. See, e.g., *Trans World Airlines v. Texaco* (In re Texaco) 81 B.R. 813 (Bankr. S.D.N.Y. 1988). In *Texaco*, Texaco entered into a settlement with Pennzoil whereby the parties agreed, among other things, that Texaco would allow Pennzoil's claim in the amount of \$3 billion and that Pennzoil would support any reorganization plan thereafter proposed by Texaco. *Id.* at 815. Rejecting Carl Icahn's argument that the agreement constituted an impermissible solicitation of acceptances by Texaco outside of the plan process, the bankruptcy court approved the settlement. *Id.* at 815-16.

Arguably what Texaco did was buy Pennzoil's vote. To appreciate how the lock-up agreement can be reconceptualized as a form of vote buying, consider the following reasoning. Presumably, Texaco would not have agreed to allow the full \$3 billion had Pennzoil not also committed itself to support any reorganization plan proposed by Texaco, either at the time or in the future. If Texaco would have agreed, absent Pennzoil's commitment, to allow, say, only \$2.9 billion of Pennzoil's claim, then Texaco effectively would have paid \$.1 billion for Pennzoil's vote, less a discount reflecting the likelihood that Pennzoil's claim would not be paid in full under the plan.

Commentators have split into two camps on the vote-buying issue outside of bankruptcy. Compare Easterbrook & Fischel, *supra* note 6, at 410 (vote buying creates agency costs and should therefore be prohibited) with Andre, *supra* note 21, at 597, 619-29 (vote buying helps to maximize shareholder wealth and does not contribute to agency costs) and Clark, *supra* note 21, at 793-94 (vote buying may promote desirable corporate control changes) and Manne, *supra* note 21 (the market for votes promotes information-gathering and rewards those who know how to use the voting shares most profitably). On balance, vote buying in bankruptcy seems problematic under either analysis, given the danger of strategic behavior by the buyer. This is especially true where, as in *Texaco*, the buyer is the debtor in possession rather than an outside party. The inevitable effect of such vote buying is to solidify the control of the debtor's current managers. For example, Texaco's managers bought the vote permanently—Pennzoil was prohibited from proposing or supporting any other reorganization plan. *Texaco*, 81 B.R. at 814-15. Such practices could thwart even desirable changes in control.

IV. COLLECTIVE ACTION PROBLEMS AND THE ROLE OF COMMITTEES IN CHAPTER 11

Parts I and II developed a two-pronged contractual analysis that both justifies shareholders' monopoly of the franchise outside of bankruptcy and, more surprisingly, also explains chapter 11's voting framework. The application of this analysis in Part III counseled, among other things, that chapter 11 needs both more votes—in that preconfirmation sales of substantial assets should be submitted to a vote, rather than left to the bankruptcy court's discretion—and, with respect to directorial elections and class approvals, a different vote. In each context, the analysis concluded that the firm's unsecured creditors should be the voters.

In this Part, I address what appears at first to be a major practical problem with the conclusions of Part III: although unsecured creditors might, in the abstract, be the firm's best decisionmakers in chapter 11, the *real* unsecured creditors of *real* publicly held chapter 11 debtors are numerous and highly dispersed. Unsecured creditors therefore are likely to face the same obstacles to effective voting—rational apathy and the incentive for individual creditors to free ride—that undermine shareholder voting outside of bankruptcy.²²⁴ If this is true, amending the Bankruptcy Code to give them the franchise in these contexts would be pointless.

I argue in this Part that the game is in fact worth the candle. After a brief theoretical overview of the logic of collective action, I examine the problems that each of the firm's major constituencies—senior creditors, unsecured creditors, and shareholders—would face were it not represented by a chapter 11 committee. I show subsequently how chapter 11 committees help the parties to surmount their collective action problems, but I also note the limitations of the committee solu-

²²⁴ See *supra* Part I.C. Collective action problems arise whenever a group comprising more than one member would benefit from provision of a collective good. Hardin distinguishes collective goods from Paul Samuelson's "public goods," which are characterized not only by impossibility of exclusion, but also by jointness of supply—that is, consumption of the good by one individual does not diminish the amount of the good available to others. Hardin, *supra* note 8, at 17-18; see Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 *Rev. Econ. & Stat.* 387, 387 (1954), reprinted in Kenneth J. Arrow & Tibor Scitovsky, *Readings in Welfare Economics* 179, 179 (1969). The reason for the distinction is the dearth of real-world examples of true public goods.

tion. Finally, I conclude that unsecured creditors should, as I originally argued, be given voting authority.²²⁵

A. The Theory of Collective Action: A Brief Overview

Recall from the discussion in Part I the irony of this familiar dilemma: if each of the members of a group acts rationally, rational apathy and free-rider problems are likely to prevent the group from supplying a collective good despite the fact that it is in the members' collective best interests to do so.²²⁶ For a deeper understanding of collective action, it is useful to consider Mancur Olson's simplest general statement of the dilemma. Olson defined the net benefit (A_i) to an individual i from i 's contribution to the provision of a collective good in terms of the following equation: $A_i = V_i - C$, where V_i is the gross benefit to i of the collective good, and C represents the cost.²²⁷ Olson argued that unless $A_i > 0$ for at least one member of the group, the group is unlikely to succeed absent coercion or other selective incentives.²²⁸ Defining groups with respect to which no individ-

²²⁵ My concern throughout this Part is with intra-class collective action problems. I do not consider the interactions among the classes in chapter 11, except to the extent that these interactions bear on the issue of decisionmaking within classes.

In brief, anecdotal evidence suggests that the constituencies of a chapter 11 debtor form unstable and largely unenforceable coalitions with one another during the course of a bankruptcy case. Senior creditors may ally initially with shareholders, for instance, and subsequently with unsecured creditors. Because these coalitions are unenforceable, they may give rise to prisoner's dilemma problems comparable to those encountered in the context of corporate decisionmaking in takeover negotiations outside of bankruptcy. Coffee, *supra* note 34, at 1533-44. Interestingly, the fact that many of the attorneys and some of the parties are likely to be repeat players suggests that the game arguably is, or could be, an iterated one, which could enhance the prospects for cooperation between members of any given coalition and thus strengthen the coalition. See Robert Axelrod, *The Evolution of Cooperation* 20-21, 124-41 (1984).

²²⁶ See *supra* notes 40-42 and accompanying text.

²²⁷ Olson, *supra* note 8, at 23; Hardin, *supra* note 8, at 20. Although Olson was not the first to point out that rational members of a group may have an incentive not to contribute to the provision of a collective good, he did generalize his analysis, whereas previous observers had expressed the logic of collective action only through specific examples. E.g., Hardin, *supra* note 8, at 21-22.

²²⁸ Olson, *supra* note 8, at 23-24. Edward Rock has recently pointed out one qualification to Olson's analysis: the important question, in actuality, is whether A_i exceeds the gains available to an individual from alternative courses of action, rather than whether $A_i > 0$. Thus, if the benefit to an individual from exiting, as when a shareholder sells her stock or a creditor her claim, exceeds the gain she would receive were she to help provide the collective good, then the individual, assuming she is rational, will exercise her exit option even if $A_i > 0$. Similarly, the individual has an incentive to contribute, even where $A_i < 0$, if her net benefit

ual meets this requirement as "latent," and groups with at least one i for whom $A_i > 0$ as "privileged," Olson concluded that the latter groups, but not the former, are likely to succeed.²²⁹

Furthermore, Olson argued that, whereas small groups sometimes are privileged, large groups are almost always latent; accordingly, he indicated that latency is directly related to size.²³⁰ Hardin disagrees. He argues that the degree of latency is related not to the number of individuals in a group, but instead to the size of its smallest efficacious subgroup, (k), which he defines to be the size of the smallest subgroup whose collective benefit exceeds the cost of providing a collective good to the entire group.²³¹

Two factors are significant to the determination of (k) for a particular group. First, the greater the benefits of collective action as compared with its costs, the smaller (k) will be.²³² Second, (k) is inversely proportional to the asymmetry of the group—that is, the smallest effi-

from contribution would exceed the benefit from any of her other alternatives. See Rock, *supra* note 49, at 455-56. See generally Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (1970) (examining in a variety of contexts the circumstances in which the exit option will prevail over the voice option).

²²⁹ Olson, *supra* note 8, at 49-50. Olson describes groups that fall just short of privileged status as "intermediate" groups. *Id.* at 50. For purposes of clarity, subsequent discussion refers only to "latent" and "privileged" groups. Rather than speaking of intermediate groups, I characterize latent groups as "mildly latent" or "highly latent" where such qualification is appropriate.

²³⁰ *Id.* at 50-51.

²³¹ Hardin, *supra* note 8, at 46. Thus, for example, a 100-member group may be more latent than a 1000-member group if the smallest group that would benefit were they to organize and provide the good themselves were 100 for the 100-member group, but only 50 for the 1000-member group. A 100-member group might have a (k) of 100 if the collective good in question were a step good—that is, none of the collective good would be provided until a threshold level of contribution had been achieved—and provision of the good were also step, in the sense that each individual's only choice would be to contribute or not to contribute, as opposed to the choice of whether to contribute coupled with a decision as to how much. See, e.g., *id.* at 51. An example borrowed from Hardin is illustrative. The collective good of Saturday morning quiet in the suburbs would not be provided in a neighborhood with 100 residents if even one of those residents decided to mow her lawn. *Id.*

For an example of a 1000-member group whose (k) is 50, assume that 50 stockholders of a corporation own a total of 51% of its stock—49 stockholders own 1% each, perhaps, and 1 owns 2%—and the remaining 950 stockholders own the remaining 49%, each owning less than 1%. If approving a proposed merger were a collective good—the merger would increase the value of the firm's stock—and approval required a 51% vote, then (k) would be 50. That is, 50 would be the smallest number of shareholders who, by casting affirmative votes, could ensure that the merger would be approved.

²³² *Id.* at 40-41.

cacious subgroup is smaller if the members of a group expect different benefits from provision of a collective good than it is if group members have identical interests.²³³ These factors play an important role in the analysis of the following Section.

B. Collective Action Problems in the Absence of Committees

The parties' collective action in chapter 11—which I referred to previously as “providing the collective good”—comprises a variety of related activities. Effective oversight of the firm's operations during chapter 11 is part of the collective good, as is negotiating on behalf of one's class, filing motions and other pleadings if necessary, and voting in an informed fashion on a proposed reorganization plan. Together, these activities can be described as “monitoring-and-contesting” the chapter 11 case.²³⁴ The purpose of this Section is to consider how likely the parties would be to monitor-and-contest actively in the chapter 11 context if they were not represented by committees. I conduct the inquiry by applying the theoretical insights of the previous Section to each of the firm's major constituencies—senior creditors, unsecured creditors, and shareholders.

The senior class of a chapter 11 firm typically consists of the debtor's lenders—frequently one or a small number of banks. Senior creditors,²³⁵ unlike the firm's unsecured creditors and shareholders, are not widely dispersed. Thus, this group may have sufficient incentive to monitor-and-contest even in the absence of committee repre-

²³³ Id. at 68. Hardin suggests that asymmetry exists where different members of a group place different values on an equivalent amount of the collective good. Id. at 67. Thus, an environmentally conscious citizen might value a clean stretch of beach much more than other citizens would. But in a corporate context, where one shareholder owned more of the target firm's stock than other shareholders and thus received most of the benefit of a takeover premium, Hardin presumably would not find “asymmetry” because every member of the group would place the same value on each share of stock. Id. at 70-71. I will use “asymmetry” to refer to each of these situations, because both have the effect of lowering the size of the firm's smallest efficacious subgroup, (k).

²³⁴ Commentators have used various terms to describe the collective good that is supplied if shareholders take an active role, through informed voting and other activities, in the governance of a firm outside of bankruptcy. Black, *supra* note 49, at 522 (calling it “shareholder voice”); Rock, *supra* note 49, at 453-54 (describing the collective good as “[d]isciplining”). I use the term “monitor-and-contest” to reflect the somewhat different role of the major “players” in a chapter 11 case. In particular, I wish to convey a sense of bankruptcy as both a participatory and an adversarial process.

²³⁵ The firm's senior creditors are often, but not always, secured. I assume for the purposes of the following analysis that they are in fact secured.

sentation, because the proportion of the benefits to each member of monitoring-and-contesting is significant enough to justify incurring the related costs.²³⁶

Moreover, even if the class is latent (that is, $A_i < 0$ for each member), the costs of coordination are usually very low, and free riding is very difficult in a class of this size. Accordingly, one might expect that its members will overcome their collective action problem. Hardin notes, for example, that "solidarity, moral suasion, or strategic interaction" favor the efforts of a small group and that the members of such a group can engage in contingent choosing—that is, each member may implicitly agree to monitor-and-contest on behalf of the class only if the other members do the same.²³⁷ The fact that secured creditors often have an incentive to play an active role does not ensure an optimal contribution so long as each member cannot receive the whole benefit of the collective good.²³⁸ Nonetheless, the secured class of creditors is the class least likely to be paralyzed by collective action problems in chapter 11.

Unlike secured creditors, unsecured creditors such as bondholders and trade creditors are likely to be numerous and widely dispersed.²³⁹ One might therefore expect a high degree of latency with respect to unsecured creditors, comparable in many respects to the status of shareholders outside of bankruptcy.²⁴⁰ If true, this observation sug-

²³⁶ Senior creditors are a classic example of what Olson described as a small, and thus potentially privileged, group. Olson, *supra* note 3, at 49-53.

²³⁷ Hardin, *supra* note 8, at 40. We might therefore expect to see secured creditors taking turns attending negotiating meetings with the debtor and other constituencies and sharing the costs of representing the class in court. Because of the number of bankruptcy "events," the collective action game appears iterated for these creditors. As noted above, see *supra* note 225, in an iterated prisoner's dilemma game, defection may not be the rational strategy for individual players; cooperation is significantly more likely.

²³⁸ Olson, *supra* note 8, at 34-36.

²³⁹ The drafters of the Bankruptcy Code were aware of this problem. They observed that debtors may have a "natural tendency . . . to pacify large creditors . . . at the expense of small and scattered public investors," but that public investors, such as shareholders and bondholders, should "have legislative assurance that their interests will be protected." S. Rep. No. 989, 95th Cong., 2d Sess. 10, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5796.

²⁴⁰ Interestingly, the benefit (V_i) of monitoring-and-contesting to an individual unsecured creditor in chapter 11 may be relatively greater than that to a secured creditor. Secured creditors are compensated first and thus receive most of their claims even if the firm performs badly. The fortunes of the firm and the success of negotiations with other constituencies, however, will directly affect the value available for unsecured creditors, but this benefit is offset by exponentially greater costs to widely dispersed unsecured creditors who wish to provide a public good as compared to secured creditors.

gests that the smallest efficacious subgroup (k) for a group of unsecured creditors usually will be extremely large. Yet the smallest efficacious subgroup of unsecured creditors may be significantly smaller than the total number of members in the class because the members of a class of bondholders or trade creditors frequently will hold claims in substantially different amounts, making these classes highly asymmetrical in nature. Thus, a firm that engages in defense contracting may owe some trade creditors—such as an office supply store—small amounts (say, \$500), and other trade creditors—a supplier of parts, for instance—much larger sums (say, \$40,000). Both are unsecured creditors, but the supplier of parts obviously can expect a much greater benefit if the class monitors-and-contests effectively. Concentration of debt in the hands of institutional or other investors creates the same kind of asymmetry with respect to a class of bondholders.²⁴¹ In short, unsecured creditors probably would not effectively monitor-and-contest in most chapter 11 cases, but concentration of large claims in the hands of relatively few investors could reduce the degree of latency in many classes.²⁴²

The benefit (Vi) to the shareholders of active monitoring-and-contesting is limited for an insolvent firm. Nevertheless, because the Bankruptcy Code gives shareholders significant leverage even in contexts where strict application of the absolute priority rule would eliminate their interests entirely, the benefits to shareholders of collective action in chapter 11 should be roughly comparable to those anticipated by unsecured creditors. The cost (C) to shareholders of monitoring-and-contesting also is similar to that to unsecured creditors because shareholders are similarly dispersed. As with unsecured creditors, the shareholders are likely to be a highly latent group, although the size of the smallest efficacious subgroup may be reduced

²⁴¹ In addition to asymmetry in the size of creditors' claims, my principal concern here, there also may be asymmetry in Hardin's sense—nonfungibility of benefits as among the members of the relevant group. Hardin, *supra* note 8, at 70. In particular, whereas some unsecured creditors, such as employees, may have a vested interest in the long-term viability of the firm, others may simply wish to ensure that the firm will survive long enough to compensate them. See Roe, *supra* note 18, at 542-44.

²⁴² Postpetition trading of claims can create this concentration and give postpetition investors a much greater incentive to monitor-and-contest than the incentives given the individual claimants from whom the investor bought her claims. See, e.g., Fortgang & Mayer, *supra* note 99, at 6-7. In an extreme case, an investor might acquire such a large stake in a class as to convert the class from latent to privileged status.

by the concentration of share ownership in the hands of institutional and other large investors.²⁴³

*C. The Impact of Chapter 11 Committees on
Collective Action Problems*

Collective action theorists have posited that highly latent groups, such as the shareholders and unsecured creditors of a publicly held chapter 11 debtor,²⁴⁴ will succeed in supplying a collective good only through coercion or selective incentives.²⁴⁵ Government intervention presents a third option.²⁴⁶ The government may provide the collective good itself or may compel the members of a group to contribute to the provision of the collective good. Chapter 11 committees are a classic example of the latter approach.²⁴⁷ Chapter 11 committees enable the parties to overcome their collective action problems in two

²⁴³ Rock, *supra* note 49, at 459. Moreover, because several of the shareholders' options outside of bankruptcy are significantly less attractive in bankruptcy, the likelihood that shareholders will have an incentive to contribute to the collective good, even if the net benefit (Δr) for an individual shareholder is negative, is enhanced. See *supra* note 228. In particular, the value of the firm's stock is likely to have plummeted, thus curtailing the shareholders' exit option. Additionally, shareholders will no longer be able to anticipate the possibility of takeover gains because an investor who wished to purchase control of a bankrupt firm would likely purchase the claims of a more senior class. See Fortgang & Mayer, *supra* note 99, at 75-76.

²⁴⁴ History provides evidence in support of the intuition that shareholders and unsecured creditors are likely to face severe collective action problems. The widespread belief that senior creditors and the management of financially troubled firms routinely colluded against widely dispersed public bondholders—that is, took advantage of bondholders' collective action problems—provided a major impetus for the bankruptcy reforms of 1938. See, e.g., Roe, *supra* note 115, at 251-52.

²⁴⁵ Hardin describes two of the most prominent selective incentives as "by-product" theory and "political entrepreneurship." By-product theory suggests that groups already organized for some other purpose will sometimes direct a portion of their resources toward provision of a collective good. Hardin, *supra* note 8, at 31-35. Political entrepreneurship describes the situation in which the desire for private gain, such as prestige or political advancement, motivates an individual to help provide a collective good for a latent group. *Id.* at 35-37. Rock has suggested that political entrepreneurship may explain recent high-profile activism outside of bankruptcy by the heads of several public pension funds. Rock, *supra* note 49, at 479-81.

²⁴⁶ Hardin, *supra* note 8, at 52, 84. Government intervention is a form of coerced contribution similar in many respects to participation in a labor union coerced, for example, by union shop rules. See Olson, *supra* note 8, at 68.

²⁴⁷ Hardin refers to government intervention of this sort as a "Baumol solution" to the collective action problem. Hardin, *supra* note 8, at 52; see also Baumol, *supra* note 8, at 180-96 (discussing circumstances under which government activity may assist individuals in attaining their desired ends).

related ways. First, committees centralize all of the functions necessary to effective monitoring-and-contesting by the class or classes of claims in question. Committees have specific authorization to consult with the debtor in possession about the administration of the case, to investigate the operations and finances of the debtor, to help draft a plan and coordinate their constituencies' votes, to request that a trustee be appointed, and to "perform such other services as are in the interest of those represented."²⁴⁸

Second, the Bankruptcy Code provides for the costs of committees to be paid as an administrative expense from the bankruptcy estate;²⁴⁹ these expenses thus have priority over distributions to shareholders and unsecured creditors.²⁵⁰ This arrangement spreads the costs of committees across all claimants. Unlike compensation for insurgents in successful proxy fights or attorneys' fees from derivative suit recoveries outside of chapter 11, compensation of chapter 11 committees does not depend on a showing of success.²⁵¹ As a result, chapter 11 committees are likely to be more effective than their counterparts outside of bankruptcy at solving collective action problems, perhaps even causing overmonitoring because of the independence of payment and success.²⁵²

²⁴⁸ Bankruptcy Code § 1103(c)(5). Congress made clear, both in the language of § 1103 and in the legislative history, its intent that committees perform an important monitoring role throughout the case. See *Creditors' Comm. v. Parks Jagers Aerospace Co.* (In re Parks Jagers Aerospace Co.), 129 B.R. 265, 268 (Bankr. M.D. Fla. 1991) (holding that creditors' committee does not automatically dissolve after confirmation of a reorganization plan because reasons may exist for the committee to continue to monitor the debtor's actions).

²⁴⁹ Bankruptcy Code § 330(a) (authorizing payment of any "professional person" employed by a committee pursuant to Bankruptcy Code § 1103); *id.* § 503(b)(2) (ensuring that the payments will be treated as an administrative expense).

²⁵⁰ *Id.* § 507(a).

²⁵¹ Because proxy contest insurgents will be compensated only if they are successful (and not for efforts expended in losing efforts or in scrutinizing management proposals that they decide not to oppose), potential insurgents will provide an inappropriate amount of monitoring. See Clark, *supra* note 21, at 781-82. Similar shortcomings plague the rules for payment of attorneys' fees in the derivative suit context. See Clark, *supra* note 16, § 9.5, at 396-97. The effectiveness of derivative suits is further limited by their post hoc nature, making them useful only in remedying actual violations, and by the likelihood that plaintiffs' attorneys' incentives will be at odds with those of their clients. John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 *Law & Contemp. Probs.* 5, 32 (1985).

²⁵² The effectiveness of committees is enhanced by the enormous leveraging effect of bankruptcy on resources directed toward providing the collective good. Because an individual group member need persuade only a bankruptcy judge of the virtue of her position, rather than

On the other hand, it may seem puzzling that the Bankruptcy Code requires that only unsecured creditors be given a committee in every case.²⁵³ Appointment of committees for other creditors and for shareholders is completely discretionary.²⁵⁴ Yet collective action theory explains even these differences. Recall that the firm's secured creditors may have sufficient incentives to monitor-and-contest in chapter 11 even without the aid of a committee. Thus, the drafters understandably denied them the right to be represented by a committee in every case. Shareholders, although facing significant obstacles to collective action, arguably have no financial interest in most chapter 11 firms because most are by then insolvent. The desire nonetheless to give shareholders substantial leverage in chapter 11 and the recognition that some chapter 11 firms are not insolvent entitle shareholders to committee representation in appropriate cases.²⁵⁵

In contrast, the firm's unsecured creditors are a highly latent group; as the residual owners of the firm, they may need, and arguably should have, a committee in every case. Notice that this representation will be especially important if the Bankruptcy Code is amended,

all or a majority of the members of her group, bankruptcy significantly reduces the costs of monitoring-and-contesting a chapter 11 case, as compared to the cost of engaging in similar activities prior to bankruptcy. Cf. Hardin, *supra* note 8, at 134-35 (noting that environmental activists, in lobbying the government to enact pollution controls, need spend only a fraction of the money that would be necessary to clean up pollution themselves or to pay individuals and firms to stop polluting); John Woestendiek, *Southern Californians Cooking Their Last with Charcoal Fluid*, *Phila. Inquirer*, July 4, 1991, at A1 (antipollution measures will present manufacturers with major expenses but cause individuals only minor inconveniences).

²⁵³ Despite the fact that the language of Bankruptcy Code section 1102(9) appears to mandate appointment of an unsecured creditors' committee, LoPucki has shown that unsecured creditors' committees are not always appointed, at least in smaller cases. Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?* (Part II), 57 *Am. Bankr. L.J.* 247, 249-53 (1983). Courts do in fact appoint at least one committee of unsecured creditors in nearly every case involving a large, publicly traded corporation. LoPucki & Whitford, *supra* note 148, at 114.

²⁵⁴ *Id.*

²⁵⁵ Shareholders should not be entitled to the increased leverage afforded by a committee in cases where the firm is deeply insolvent. In such a case, creditors effectively would be subsidizing the representation of a class that has no colorable financial interest in the firm, for payment of the equity committee's expenses will diminish the recovery available to the creditors. The decided cases generally support this view. E.g., *In re Emons Indus.*, 30 B.R. 692, 694 (Bankr. S.D.N.Y. 1985) ("generally no equity committee should be appointed when it appears that a debtor is hopelessly insolvent"); see 5 Collier, *supra* note 59, ¶ 1102.02, at 1102-22 to -23; see also LoPucki & Whitford, *supra* note 84, at 159-60 (suggesting that shareholders are more likely to participate in reorganization distributions if they are represented by an equity committee).

as this Article recommends, to give unsecured creditors voting control over preconfirmation sales of substantial assets and directorial elections.

The analysis thus far depicts chapter 11 committees as a well-crafted response to the parties' collective action problems. Committees provide an organizational structure, together with an appropriate taxing mechanism, to those classes that most need them. Nevertheless, the committee solution suffers from several significant shortcomings.

The first stems from agency costs that arise from the committee's acting in essence as an agent for the class.²⁵⁶ The key question, then, is how significantly these agency costs impair the effectiveness of committees. Unlike the agency relationship between managers and the firm, where managers own only a small proportion of the firm's stock and thus have questionable decisionmaking incentives, the Bankruptcy Code contemplates that the seven largest members of the relevant group will serve on its committee.²⁵⁷ Although the incentives of these seven members will not perfectly mirror those of the group, these representatives are likely to have a major financial stake in the results of the group's efforts; this should diminish agency costs.

It is far from clear that these seven members will dictate the posture of any given committee, however. The attorneys and other professionals engaged by committees inevitably play a crucial role in the process. If the attorneys conduct negotiations among themselves, rather than in their clients' presence, for instance, they may largely determine the direction of a given case.²⁵⁸ Although this agency problem does not destine chapter 11 committees to failure, because attorneys and other professionals still have a strong incentive to satisfy the needs of their committee,²⁵⁹ the alignment of interests is likely to be

²⁵⁶ See sources cited *supra* note 14.

²⁵⁷ Bankruptcy Code § 1102(b)(1) (committees "shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims" or seven largest amounts of equity securities).

²⁵⁸ LoPucki & Whitford, *supra* note 84, at 154 ("reorganization plans are not directly negotiated by the parties in interest, but rather by intermediaries functioning as the parties' representatives").

²⁵⁹ See, e.g., Hardin, *supra* note 8, at 107-08. Hardin notes that although one should view with skepticism the motives of an organization's leaders, their self-interest may dovetail for the most part with the goals of the group, in that leaders will retain their status only to the extent they can persuade their constituency of the effectiveness of their leadership. *Id.* at 108.

imperfect at best. LoPucki and Whitford point out, for instance, that attorneys for the various parties may wish to preserve good relations with one another, even at the cost of failing to pursue fully their clients' interests, because they expect to see one another again in future chapter 11 cases.²⁶⁰ In this sense they are like Hardin's political entrepreneurs.²⁶¹ The attorneys enable a constituency to overcome its collective action problems, but in doing so they may pursue a personal agenda that diverges in significant respects from the groups' best interests.²⁶²

A second problem with chapter 11 committees stems from the breadth of their coverage. Consider the unsecured creditors of a publicly held firm. The unsecured creditors of large corporations comprise distinct and potentially conflicting classes,²⁶³ yet the Bankruptcy Code contemplates that a single committee will represent them all. Bringing diverse classes of unsecured creditors together under a single umbrella may not create difficulties in some contexts, such as monitoring the operations of the firm. In others, however, collective action problems will reemerge: a single committee cannot possibly effectively represent each of three or four different classes with frequently divergent interests in the parties' negotiations on division of the reorganization pie. The Bankruptcy Code does specifically authorize the United States trustee (or the bankruptcy court, after notice and a hearing)²⁶⁴ to appoint additional committees if she deems them necessary to effective representation. For example, in *In re Johns-Manville Corp.*, the court appointed several committees of unsecured creditors—including committees for institutional and trade creditors, for asbestos manufacturers, and for asbestos health claimants—in recognition of the

²⁶⁰ LoPucki & Whitford, *supra* note 84, at 156.

²⁶¹ Hardin, *supra* note 8, at 35-37.

²⁶² Rock, *supra* note 49, at 481. Rock argues that whereas the heads of public pension funds similarly may help provide the collective good of shareholder discipline outside of bankruptcy, "their incentives drive them to champion the kinds of activities that garner political benefits but do not benefit the corporation." *Id.*

²⁶³ Typically there are at least three distinct classes of unsecured creditors of a publicly held firm: senior debenture holders, subordinated debenture holders, and trade creditors. Often there will be more.

²⁶⁴ Bankruptcy Code § 1102(a)(1). The bankruptcy court originally appointed committees. The drafters of the Bankruptcy Code transferred this responsibility to United States trustees to avoid the appearance of favoritism on the part of bankruptcy judges. House Report, *supra* note 51, at 101; 5 Collier, *supra* note 59, ¶ 1102.01, at 1102-4.

substantially different interests of the various groups.²⁶⁵ Yet *Johns-Manville* is exceptional in this respect. Based, presumably, on an implicit conclusion that the advantages of additional committees are likely to be more than offset by a substantial duplication of costs, the United States trustee (and the court) frequently appoint only one committee for unsecured creditors.²⁶⁶

A final shortcoming of chapter 11 committees is their inability to secure the participation of some or all of a group's seven largest members, either because of time constraints or, more importantly, because of the limitations committee membership may place on their ability to buy and sell claims on the chapter 11 debtor.²⁶⁷ Investors who have acquired or augmented their stake in the firm through postpetition trading of claims as well as institutional investors²⁶⁸ are especially likely to chafe at the possibility that serving as a committee member will preclude them from trading claims in the future.

D. Free Agents in Chapter 11: Participation by Individual Claimants and Interest Holders

From a collective action perspective, then, the chapter 11 committee structure enjoys only mixed success. Providing an organizational structure and a taxing mechanism facilitates monitoring-and-contesting by highly latent groups such as classes of unsecured creditors

²⁶⁵ In re *Johns-Manville Corp.*, 60 B.R. 842, 844-45 (S.D.N.Y.), rev'd on other grounds, 801 F.2d 60 (2d Cir. 1986) (describing the bankruptcy court's appointment of committees).

²⁶⁶ See LoPucki & Whitford, *supra* note 84, at 139. Another possible solution to the problem of diverse strategic interests is for the United States trustee to ensure that each of the divergent classes secures representation on the committee. Thus, the United States trustee might appoint at least one senior unsecured creditor, one trade creditor, and one subordinated unsecured creditor to the committee of unsecured creditors, regardless of whether each qualified as one of the seven largest unsecured claimants. This solution addresses both the problem of duplicative costs and the belief that diverse interests need representation. The committee as a whole still would fail to represent each of the diverse interests, however. Rather than champion the interests of each of its constituent classes, the committee would likely abstain from negotiations that pitted one unsecured class against another, and instead would limit its efforts to those aspects of the case as to which unsecured creditors' interests were consistent.

²⁶⁷ Committee members are likely to receive inside information about the firm. Although the Bankruptcy Code does not explicitly forbid committee members from trading on such information, as Fortgang and Mayer note, "prudent attorneys should advise any client who serves on a committee . . . that the bankruptcy laws prohibit fiduciaries from trading in the claims or stock of the debtor." Fortgang & Mayer, *supra* note 99, at 33.

²⁶⁸ See Rock, *supra* note 49, at 494 n.196.

and shareholders, but agency costs, overly broad coverage, and possible nonparticipation suggest that committees inefficiently promote the interests of their constituencies.

Interestingly, claimants and shareholders with a significant stake in a publicly held debtor sometimes do act on their own initiative, rather than simply relying on a committee to represent their interests. Activity of this sort provides empirical evidence (at least of the anecdotal variety) for the contention that committees provide highly imperfect representation. Yet this activism also raises a question: if the analysis above correctly characterizes shareholders and unsecured creditors as highly latent groups, making collective action illogical in the absence of chapter 11 committees, why do we nevertheless see individuals monitoring-and-contesting? We would expect that regardless of how poorly their committee functioned, individual claimants and interest holders would have insufficient incentives to act alone on behalf of the group.²⁶⁹

On closer examination, the apparent incongruity of individual claimant activism is less surprising. Hardin has observed that groups sometimes overcome their initial latency by "piggybacking"—that is, by borrowing the infrastructures of extant organizations.²⁷⁰ He suggests that the use by early environmental groups of existing nature appreciation groups and the use by the Southern civil rights movement of churches are illustrations of this phenomenon.²⁷¹ This insight also helps explain the activism of individual claimants and shareholders in chapter 11. These individuals rely on their committee to perform the vast majority of monitoring-and-contesting. They often go so far as to model the pleadings they file (and the positions they take) on motions filed by the committee. One suspects that the level of individual participation would drop dramatically in the absence of this

²⁶⁹ One possible explanation is that these individuals are motivated by extrarational incentives, such as anger, fear, or ethical concerns. See Hardin, *supra* note 8, at 101-24. Examples of such behavior are when the individual investors in a failed real estate venture, or the employees of a local business, attend the first meeting of the debtor's creditors, convened under Bankruptcy Code § 341, for the purpose of venting their emotions concerning the debtor's financial collapse. In the discussion that follows, I ignore extrarational considerations because they do not seem to be the principal reason that large investors sometimes participate in the chapter 11 case of a publicly held firm.

²⁷⁰ Hardin borrows the term "piggybacking" from Bernard Grofman. See Hardin, *supra* note 8, at 43 n.11.

²⁷¹ *Id.* at 43-44.

committee activity.²⁷² In short, piggybacking appears to play a crucial role in enabling individual claimants or interest holders to contribute in a meaningful way to the monitoring-and-contesting that takes place in chapter 11.

The Bankruptcy Code arguably encourages such activism by providing the means to reward it. Section 503(b)(3) authorizes a court to reimburse as an administrative expense the "actual, necessary expenses" incurred by, among others, creditors and shareholders who "[make] a substantial contribution" to the case.²⁷³ Although a bankruptcy court's determinations as to whether and to what extent an individual activist should be compensated for her efforts is subject to many of the same imperfections that undermine the proxy contest and derivative suit rules outside of bankruptcy,²⁷⁴ courts could, and should, look to this section as a means of compensating for the limitations of the chapter 11 committee structure. Compensating activism by individual claimants is surely much less expensive than appointing additional committees to ensure that the interests of every class enjoy adequate representation.

E. Are Unsecured Creditors Still the Right Voters?

The suggestion that chapter 11 committees resolve the collective action problems of unsecured creditors and shareholders in only an imperfect way returns us to the question with which this Part began: should the Bankruptcy Code be amended to give unsecured creditors voting control over preconfirmation sales of substantial assets and directorial elections?

²⁷² Empirical evidence would be particularly useful here in helping to understand better the nature and extent of individual activism. The analysis in the text suggests that this activism occurs in contexts where the interests of the various classes represented by a committee are divergent, or where the ratio of the benefits to an individual of monitoring-and-contesting to their cost (V_i/C) is particularly high.

²⁷³ In addition, Bankruptcy Code § 503(b)(4) authorizes payment of the "actual, necessary expenses" of an attorney or accountant of such creditors and shareholders. Courts in some cases already compensate individual claimants, interest holders, and their attorneys, pursuant to § 503. Although they generally deny compensation for activities that benefit only the individual creditor, see, e.g., *In re Johnson*, 126 B.R. 808 (Bankr. M.D. Fla. 1991), courts have awarded fees to creditors who objected to a reorganization plan that failed to provide for interest payments on the claims of unsecured creditors, *In re Lehal Realty Assocs.*, 112 B.R. 588 (Bankr. S.D.N.Y. 1990), or who mediated disputes between the debtor and the creditors' committee. *In re Baldwin-United Corp.*, 79 B.R. 321 (Bankr. S.D. Ohio 1987).

²⁷⁴ See *supra* note 251.

With respect to choosing directors in chapter 11, the change clearly would be an improvement over the current regime. Although committees provide only an imperfect solution to unsecured creditors' collective action problems, shareholders face precisely the same obstacles. Given unsecured creditors' better decisionmaking incentives, it is more appropriate that they be the voters in the event of an election.

The question of whether unsecured creditors or bankruptcy judges are likely to make better decisions on preconfirmation sales is somewhat closer. Again, however, amending the Bankruptcy Code appears to be the preferable choice. Despite their imperfectly resolved collective action problems, unsecured creditors have much more at stake and can therefore be expected to wield their influence more effectively.

CONCLUSION

This Article recommends several changes to the way bankruptcy courts and the Bankruptcy Code currently treat corporate voting in the chapter 11 context. Each proposal is at bottom a suggestion that courts and the Bankruptcy Code should stick more closely to the normative principles reflected in state law corporate voting provisions. Amending the Code to effect these proposals could considerably improve an already well-crafted network of corporate voting rules.

The Article also offers a preliminary inquiry into the nature of the parties' collective action problems in chapter 11. This area seems a particularly promising topic for further study.