CREDITORS’ BALL: THE “NEW” NEW CORPORATE GOVERNANCE
IN CHAPTER 11

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For well over a year now, the papers have been filled with hand-wringing about the sorry state of American corporate governance. We read that Wall Street’s watchers—the securities analysts and auditors especially—were so riven with conflicts of interest during the stock market boom that the only thing they watched was their own bank accounts. The former chairman of the SEC is barnstorming the country as I write this, telling everyone that he tried to warn us back in the 1990s. The SEC needed more money, he says, among many other complaints, and more freedom from political interference in order to do its job.²

For the companies that epitomized the governance crisis, bankruptcy is now where the action is. Nearly all of them—Enron, WorldCom, Adelphia, Global Crossing— are currently doing their business in Chapter 11. An observer who followed the bankruptcy literature (and the occasional New York Times or Wall Street Journal article) in the 1990s and who’d lost touch

¹ Professor of Law, University of Pennsylvania. I am grateful to Barry Adler, William Bratton, Jesse Fried, Melissa Jacoby, Bruce Markell, Bob Rasmussen, Bill Schorling, Alan Schwartz and Michael Whincop; to the Bankruptcy and Creditors’ Rights practice group of Klett, Rooney Lieber & Schorling; and to participants at the University of Pennsylvania Law Review’s Corporate Control Transactions symposium for helpful comments; and to the University of Pennsylvania Law School for generous summer funding.

² The ex-chair is Arthur Levitt, and the complaints are chronicled in his book, which is the occasion for the tour. ARTHUR LEVITT, JR., TAKING BACK THE STREET (2002).
since then might well have expected the filings to prompt a second round of hand-wringing, this
time about America’s miserable bankruptcy framework. A decade ago, many observers believed
that Chapter 11 was irretrievably flawed. Yet here we are, only a few years later, and
surprisingly few people seem to be complaining about bankruptcy. One hears occasional
worries, to be sure. There was a brief flurry of articles suggesting that Chapter 11 may be too
“biased toward saving failing firms,” and there have been running accounts of the size of the
professionals’ fees in the Enron case. But these days bankruptcy is more often described as a
solution than as a problem.

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

Both of these explanations are at least partially true. But I plan to focus on a third
explanation, the fact that Chapter 11 decision making itself has changed quite dramatically in the
past decade. The endless negotiations and mind-numbingly bureaucratic process that seemed to
characterize bankruptcy in the 1980s have been replaced by transactions that look more like the
market for corporate control. Whereas the debtor and its managers seemed to dominate

3 For discussion of the concerns, and a critique of the principal proposals to replace
Chapter 11 with an alternative regime, see, e.g., David A. Skeel, Jr., Markets, Courts, and the

4 Daniel Altman, Chapter 11? Or Time to Close the Books?, N.Y. TIMES, Dec. 15,
2002, at Bus. p.1 (quoting Michelle White)(internal quotes omitted). See also Sarah McBride,
Australia’s Tough-Minded Bankruptcies May Serve as Role Model, WALL ST. J., Dec. 16,
2002, at A2 (asking whether “the U.S. system— one that follows a ‘rescue’ approach ...-- wastes
economic resources, diverts funds to hefty legal and consulting fees and slows down overall
economic growth”).
bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast. Chapter 11 no longer functions like an antitakeover device for managers; it has become, instead, the most important new frontier in the market for corporate control, complete with assets sales and faster cases.

Unlike the “new” bankruptcy governance that was ushered in by Congress in 1978, the “new new” Chapter 11 governance is contractual in nature. Creditors have converted two existing contractual tools into important governance levers. The first is debtor-in-possession financing. Before they even file for bankruptcy, corporate debtors need to arrange an infusion of cash to finance their operations in Chapter 11. To an increasing extent, lenders are using these loan contracts to influence corporate governance in bankruptcy. The fate of an asset or division of the company, even the terms of a transfer of control– all of these things have been spelled out as terms in a debtor’s DIP financing agreement. Second, key executives are increasingly given performance-based compensation packages in Chapter 11. The most common strategy is to

5 Chapter 11 replaced the much harsher provisions of the previous Bankruptcy Act with provisions permitting the debtor’s managers to continue running the business, giving them the exclusive right to propose a reorganization plan for the first 120 days of the case, and relying on negotiations between the debtor and its creditors to effect the reorganization. For a detailed discussion of the history and implications of Chapter 11’s new governance regime, see DAVID A. SKEEL, JR., DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 160-83, 212-37 (2001).


7 Another important development— albeit one that was well underway in the 1980s— is the role of the market for claims in Chapter 11. I have discussed this development, and its use as a device for acquiring control of the corporate debtor, in other work. See, e.g., Robert Rasmussen & David A. Skeel, Jr., The Economic Analysis of Bankruptcy Law, 3 AM. BANKR. INST. L. REV. 85 (1995); David A. Skeel, Jr, The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 VA. L. REV. 461, 513-18 (1992).
promise the executives a large bonus if they complete the reorganization quickly, and increasingly smaller bonuses if the case takes longer.

My aim in this Article is to make sense of these developments, both by putting them into historical context, and by identifying the concerns they raise. The discussion proceeds as follows. Part I describes the complaints about Chapter 11 in the 1980s and the increasing use of DIP financing agreements and performance-based pay to reshape Chapter 11 governance. Part I also explains how creditors can influence the composition and focus of the debtor’s board of directors during the bankruptcy case. Part II briefly summarizes the virtues of the new Chapter 11 governance. In Parts III and IV, I consider some of the concerns raised by each of the governance levers. With DIP financing (the subject of Part III), I point out that the DIP lender’s priority status can produce a variety of troubling effects. An existing lender may use the new financing arrangement to improve its prebankruptcy position. Some lenders may also have too great a bias toward liquidation, which could hurt creditors as a whole, and in coming years could undermine an aspect of Chapter 11 that I refer to as its “antitrust benefit.” With executive compensation (Part IV), I argue that prebankruptcy bonuses raise serious fairness and efficiency concerns, but that the concerns are much weaker in the post-petition environment.

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

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

The worst offender of all was Eastern. Although it was clear to just about everyone that Eastern should be sold, Eastern’s CEO Frank Lorenzo postponed the inevitable for several years, as Eastern’s value deteriorated. In the end, Eastern’s assets were liquidated at a fraction of what they had been worth at the outset of the bankruptcy case.

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8 As noted earlier, I have discussed these developments in detail elsewhere. See supra note [5].

9 See, e.g., Lynn M. LoPucki, The Trouble with Chapter 11, 1993 WISC. L. REV. 729 (surveying data on case duration).

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

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


12 For discussion, see Rasmussen & Skeel, supra note [7].

13 The current airline bankruptcies– U.S. Air and United– are a particularly good example. In United, the lenders’ cost reduction requirements have induced the company to make major layoffs, see, e.g., Susan Carey, UAL Will Lay Off 1,500 Workers as Part of Cost-Cutting Strategy, WALL ST. J., Jan. 6, 2003, at A3; and U.S. Air’s principal lender threatened to force a liquidation unless unions agreed to major paycuts. Micheline Maynard, US Air’s Chief Lender Threatens the Ultimate, N.Y. TIMES, Dec. 7, 2002, at C1.
How did everything change so fast? In part, the transformation reflects a change in the profile of American business. Unlike the businesses that traditionally landed in bankruptcy—railroads, in the old days, or industrial firms thereafter—many contemporary businesses depend on knowledge and ideas rather than hard assets. Because these companies’ most important assets can walk out the door at any moment, they cannot afford to negotiate for months or years toward an eventual restructuring. They must resolve their difficulties immediately; often, the only way to do this is to sell key assets at or shortly after the time of bankruptcy.14

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

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

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14 See, e.g., David A. Skeel, Jr., *The Fall of Enron*, PHILA. INQ., Dec. 9, 2001 (characterizing these developments as “New Economy Bankruptcy”). The shift in asset profile is a central theme of Douglas Baird and Bob Rasmussen’s work proclaiming the “end” of bankruptcy. Baird and Rasmussen also emphasize the development of sophisticated financial contracts that can be used to shift control rights outside of bankruptcy. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002).
A. Debtor in Possession Financing: Creditors’ New Power Tool

When commentators talk about what distinguishes Chapter 11 from other countries’ corporate reorganization laws, they increasingly point to debtor-in-possession financing as a crucial benefit of Chapter 11. The magical provision is section 364. What makes this section special is that it authorizes the bankruptcy court to roll out the red carpet for a lender that is willing to make a new loan to the debtor. For starters, the court can treat the DIP loan as an administrative expense, which puts it behind only existing, secured lenders in the priority hierarchy. If the debtor has unencumbered assets, the court can give the DIP lender a security interest in those assets, thus putting the DIP lender on the same footing as the company’s secured creditors. If most or all of the debtors’ assets are already spoken for, section 364 provides its most dramatic option of all. The court can give the DIP lender a so-called “priming lien”-- that is, a security interest that takes priority even over existing security interests in the same collateral.

Debtor-in-possession financing dates back well over a century, to the equity receiverships that were used to reorganize troubled railroads, and which effected the first large


scale corporate reorganizations in America. In order to facilitate short term financing to pay suppliers and other essential creditors, courts created a device known as the “receiver’s certificate.” The receiver’s certificate gave a special priority—sometimes trumping even senior liens— to investors who contributed new funds to the troubled enterprise. This enabled even the most debt-laden railroad to raise money to pay short-term expenses during the reorganization process.

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

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17 The emergence of the equity receiverships is recounted and explained in SKEEL, supra note [5], at 48-70.

18 For a discussion of the role receiver’s certificates played in addressing the debt overhang problem, see, e.g., Peter Tufano, Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century, 71 BUS. HIST. REV. 1, 8-9 (1997).

During this same era, courts permitted the debtor to pay suppliers in cash, even if senior creditors had a lien on the railroad’s income, pursuant to the so-called six months rule. See, e.g., James Byrne, Foreclosure of Railroad Mortgages in the United States Courts, in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, at 77, 123-24 (1917). As with receivers’ certificates, the six months rule assured that suppliers would not cut the debtor off.

19 See, e.g., SKEEL, supra note [5], at 58-59.
paid a cash “assessment” in return for the privilege of retaining an interest in the reorganized railroad.\textsuperscript{20}

To understand why today’s post-petition financers figure so much more prominently than did their ancestors, the investors in receivers’ certificates, we need to add one more historical detail: in the 1930s, as part of their rebellion against Wall Street’s influence, the New Deal reformers booted the Wall Street investment banks and lawyers out of large scale reorganization practice.\textsuperscript{21} Chapter X of the Chandler Act, which was drafted largely by future Supreme Court Justice William Douglas, achieved this goal by requiring that the debtor’s managers be replaced by a court-appointed trustee, and by prohibiting any bankers or lawyers who had represented the debtor prior to bankruptcy from playing any role in bankruptcy. The number of large corporate bankruptcies plummeted,\textsuperscript{22} and Wall Street disappeared for decades.

After the 1930s, the principal method for financing large corporate reorganizations was through retained earnings and bank loans. Because corporate debtors do not have to make ongoing payments on their pre-bankruptcy debt during the case, they may be able to accumulate cash. But they may also need new funding, and, even if they don’t, the cash coming in is often subject to the security interest of the bank who lent the company money prior to bankruptcy. Before a corporate debtor can use the new cash, it must obtain a cash collateral order that is

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\textsuperscript{20} See, e.g., Tufano, \textit{supra} note [18], at 10-19 (describing how court’s tendency to set low “upset” prices pressured security holders to agree to pay the assessment).

\textsuperscript{21} For discussion, see, e.g., SKEEL, \textit{supra} note [5], at 109-127.

\textsuperscript{22} Id. at 125 (noting that the number of large reorganizations dropped from more than five hundred in 1938 to roughly one hundred per year as of the mid 1940s).
\end{footnotesize}
designed to protect the bank’s interest while the debtor uses the cash.\textsuperscript{23}

Notice the dramatic shift in bankruptcy finance that has taken place. Banks were at the center of the process in the nineteenth and early twentieth century, and they are in the center of it now. But we are talking about different banks. In contrast to the equity receivership era, when investment banks ran the show, bankruptcy finance is now the domain of the commercial banks.\textsuperscript{24}

In the past decade, post-petition financing has become more important than ever before.\textsuperscript{25} The large firms that filed for bankruptcy in the 1980s often had a large amount of unsecured debt and comparatively little secured debt. As a result, when they filed for bankruptcy, the cash generated by the business was not all spoken for, and the debtor could use this cash to finance the reorganization effort. The large companies that have filed for bankruptcy more recently have often relied more heavily on secured debt prior to bankruptcy, and thus have less cash to work with. Lenders have responded both to the greater importance of post-petition financing, and to creditors’ concerns about the Chapter 11 process, by using the terms of DIP loans to shape the Chapter 11 case.

\textsuperscript{23} 11 U.S.C. section 363.

\textsuperscript{24} This is not to say that investment banks have no role in Chapter 11. To the contrary, they figure quite prominently, but they perform functions like consulting on and facilitating asset sales, rather than serving as underwriters.

I should also note that the investment banks of the early twentieth century– J.P. Morgan and its peers– also engaged in commercial banking. But their role in corporate reorganization stemmed principally from their investment banking activities.

\textsuperscript{25} For evidence of the increasing use of DIP lending, see, e.g., Sris Chatterjee et al, \textit{Debtor-in-Possession Financing}, at 7 (unpublished manuscript, May 31, 2002)(finding that “the number of firms obtaining DIP financing increased significantly during the 1990s from 27% in the early 1990s to 46% in the late 1990s”).

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The financing of U.S. Air’s bankruptcy is a particularly striking illustration of the recent trend. At the outset of its reorganization case, U.S. Air entered into an agreement to borrow up to $740 million from the Retirement Systems of Alabama—$240 million up front, $300 million during the case, and $200 million after U.S. Air emerges from Chapter 11. The lender assured its influence over the airline’s governance, and paved the way to take over after bankruptcy, by bargaining for five seats on the twelve member board of directors and a promise of 37.5% of the stock of the newly reorganized company.26 The U.S. Air financing is thus structured as, in effect, a partial takeover. In many cases, the lender isn’t planning to take over the company. But even in these cases, the lenders frequently use their DIP financing agreement to constrain the debtor’s managers’ wiggle room.27 It is not an overstatement to say that the terms of the debtors’ postpetition financing regularly set the course, and even the outcome, of the Chapter 11 case.

26 The Alabama pension subsequently negotiated for control over two more directors (bringing the number to seven) and agreed to lower its equity stake when U.S. Air emerges to 36%. See, e.g., Michelle Maynard, U.S. Air’s Chief Lender Threatens the Ultimate, N.Y. TIMES, Dec. 7, 2002, at C1.

27 Recent DIP financing agreements have required, for instance, that the debtor sell specified assets or liquidate if they are not generating profits within the first few months of the case. The interim financing agreement in the FAO Schwartz bankruptcy is a particularly explicit illustration— it calls for a liquidation unless the debtor confirms a reorganization plan by April 4, 2003. Even more commonly, lenders require that the debtor meet specified cash flow targets as a prerequisite to further extensions of credit under a revolving credit agreement. In the United Airlines bankruptcy, for instance, these cash flow targets are designed to force United to extract deep concessions from its unions. See, e.g., Marilyn Adams, Low-Cost Carrier Plan Trips Up UAL, USA TODAY, March 14, 2003, at 3B (UAL planning to break labor contracts to meet cash flow targets).
B. Keeping the Managers’ Nose to the Grindstone: Executive Compensation in Ch.11

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

Managerial compensation arrangements are designed to address each of these issues. Start with managers’ willingness to stay with the sinking ship. The payments used to entice managers to stick around during the bankruptcy case are usually referred to as “retention bonuses” or “pay to stay.” It is not hard to appreciate why a debtor’s managers might welcome the “pay to stay” strategy—indeed, the debtor’s managers are ordinarily the ones who put forward the proposal. From creditors’ perspective, on the other hand, the decision whether to sign off on these bonuses is more complicated. After all, there is something a bit odd about begging the same managers who navigated the firm into bankruptcy to keep up the good work. Despite their reservations, creditors increasingly have concluded that they are better off paying to keep the debtor’s existing managers in place, since these managers know the business best and the process of hiring new managers and getting them up to speed could prove time consuming and disruptive. According to one compensation expert, “the widespread use of pay-to-stay

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28 I am oversimplifying here when I characterize “creditors” as the source of these arrangements. As noted below, the agreements are proposed by the debtor-in-possession, but this almost always occurs after consultation with the creditors committee.

bonuses is a shift from the last economic slowdown in the early 1990s.” Although retention bonuses were used in a few cases (such as the Federated Department Stores bankruptcy) in the late 1980s and early 1990s, he points out, “creditors warmed to the idea on a larger scale after watching retail and electronics-chains suffer through major executive flight.**

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

Now, simply paying managers to stay doesn’t necessarily ensure they will reorganize the company efficiently. This is where pay-for-performance, the second new innovation in bankruptcy compensation, comes into play. Rather than paying managers a straight cash salary in Chapter 11, creditors have insisted in recent cases that the managers’ compensation be tied to

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30 Id. (quoting David R. Williams, compensation expert with Pricewaterhouse-Coopers).


32 In some cases, creditors have agreed to foot the bill for retention bonuses directly. In the Washington Group International bankruptcy, the debtor’s lenders agreed to fund bonuses for 490 key employees (some of which could receive as much as $29 million) in return for all of the stock in a new company that would acquire WGI’s assets. Although the plan created consternation among WGI employees who weren’t included in the plan, the court approved the bonus plan. See Richard Korman, *Pay-to-Stay Plan Miffs Employees*, ENGINEERING NEWS-RECORD, June 18, 2001, at 12; see also Cynthia Vinarsky, YOUNGSTOWN VINDICATOR, May 1, 2001 (promise by lenders to pay bonuses in connection with liquidation of CSC Ltd). [check final outcome at WGI].

33 Nor, unless the bonuses are paid out in installments, does it even ensure that that will stay, as we learned at the outset of the Kmart bankruptcy.
the progress of the Chapter 11 case. The most straightforward strategy for rewarding managers who handle the case expeditiously is to base their compensation at least in part on the speed of the reorganization case.34

Another pay-for-performance strategy comes into play if the debtor is expected to sell some or all of its assets in connection with the Chapter 11 case. Creditors can maximize the managers’ incentive to obtain the highest price possible by giving them a piece of the action, and this is exactly what they have done in a number of recent cases. In the Enron bankruptcy, for instance, the compensation scheme is designed to give the managers bonuses for quickly selling the debtor’s assets.35 In other cases, managers’ bonuses have been based not on the speed, but on the price they obtained in the asset sale.

We don’t expect to see both of the new governance strategies we have been discussing at work in every given case, of course. DIP financing is most likely to be used as a governance

34 WorldCom’s retention bonus plan, for instance, provides for “Plan Progress Bonuses” that start out at 10% of the value of the initial retention bonus. Under the plan, key employees are entitled to 100% of the progress bonus if a reorganization plan is confirmed in December 2003, 150% for a November 2003 confirmation, 200% for an October 2003 confirmation, and 250% for confirmation by September 30, 2003. Motion of the Debtors Pursuant to Sections 363(b) and 105(a) of the Bankruptcy Code for Authorization to Establish a Key Employee Retention Plan, p. 7 (Oct. 18, 2002). See also Lorene Yue, Kmart Lines Up Case for New Boss, DET. FREE PRESS, April 5, 2002 (request to approve 2 year contract that would include $2.5 signing bonus, $1 million in salary per year, and $4 million bonus if reorganization completed by July 2003; bonus would decrease by $7299 per day thereafter, and disappear if Kmart failed to emerged by April 30, 2004);

lever when there is a takeover offer on the table or it is clear which divisions a debtor needs to be selling. To give the most striking recent example, the debtor-in-possession financing of TWA was conditioned on the prompt consummation of TWA’s acquisition by American Airlines.\textsuperscript{36}

Where the direction is less obvious, as in the WorldCom bankruptcy, creditors are less likely to dictate the course of the case through the DIP financing agreement, and more likely to lean on pay-for-performance strategies as the principal mechanism for moving cases along.

It is also worth emphasizing that the “creditors” involved in DIP financing overlap with but are not identical with the ones who help hammer out the terms of managerial compensation. DIP financing comes from one or a small group of lenders who can impose explicit governance conditions on their lending.\textsuperscript{37} With managerial compensation, on the other hand, creditors generally work through the creditors’ committee as a whole, and their influence is not quite so direct. The debtor-in-possession, rather than the committee, is usually the one that asks the court to approve a pay or bonus package. But the creditors’ committee’s fingerprints are usually all over the proposal. The pay package is typically pre-negotiated with the committee, and the debtor’s managers will be hesitant to file the motion for approval unless the committee is on board.\textsuperscript{38}


\textsuperscript{37} See, generally Chatterjee et al, \textit{Debtor-in-Possession Financing}, at 11(unpublished manuscript, May 31, 2002) (finding that 90\% of DIP loans impose explicit restrictions on the debtor’s operating activities). DIP lenders also force changes-- and sometimes effect a “slow liquidation”-- through their control over subsequent loan disbursements.

\textsuperscript{38} Major creditors or the creditors committee itself sometimes object to proposed compensation packages, but these objections are lodged for strategic reasons or because of a breakdown in the discussions on the pay package, not because creditors disapprove of performance based pay. Interview with Bill Schorling, Klett, Rooney & Schorling (Dec. 18,
One last caveat: the creditors’ committee obviously isn’t involved-- by definition, it doesn’t even exist yet-- if the debtor decides to dole out retention bonuses before it files for bankruptcy. A complete account of the new governance levers will need to take eve-of-bankruptcy compensation into account, too, so I will throw this into the mix when we return to the issue in Part IV.

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

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

Not so long ago, most observers assumed that a company’s directors should be, or at the least were, beholden to the company’s shareholders in Chapter 11, just as they are outside of bankruptcy. Based on this reasoning, shareholders sometimes asked for the right to hold a shareholders’ meeting in order to elect a new set of directors during the Chapter 11 case.39

39 For a discussion of the cases, and a defense of shareholders’ right to hold a meeting during bankruptcy, see, e.g., Mark E. Budnitz, Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should the Meeting be Canceled Altogether?, 58 GEO. WASH. L. REV. 1214 (1990). For an argument that shareholders generally should not have this power, see David A. Skeel, Jr., The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 VA. L. REV. 461, 505-513.
Courts were generally sympathetic to these requests, except in cases where the shareholders seemed intent on derailing the reorganization process. The related issue of whether existing directors continue to listen to shareholders, or turn their ears to creditors, after the company files for bankruptcy is more subtle; it’s not always easy to determine a director’s loyalties, and the empirical data was mixed. Sometimes directors seemed to take their cues from shareholders, but this wasn’t always the case.⁴⁰

In the early years of the new millennium, many observers have forgotten all about the old assumption that shareholders call the directorial tune in Chapter 11. Newspaper accounts sometimes suggest, for instance, that a new manager cannot be brought on unless the creditors “approve.” Strictly speaking, this isn’t true. Creditors’ powers are much less direct. To appreciate the precise nature of creditors’ influence, as well as its limits, we should briefly consider the leverage creditors have at their disposal.

Creditors have two principal ways to influence the board once the debtor files for bankruptcy.⁴¹ First, creditors can threaten to ask the court to appoint a trustee unless the CEO or one or more board members is replaced by a manager—often a corporate restructuring officer—who is more acceptable to the creditors.⁴² This is a powerful threat, but it is also both blunt and


⁴¹ This assumes that the debtor’s DIP financer has not negotiated for directorial changes as part of the DIP financing agreement. DIP financing is almost always arranged before the case is filed, and, as noted earlier, *see supra* note [26] (discussing U.S. Air), lenders have sometimes insisted on board representation.

indirect. Replacing the debtor’s managers with a trustee is a draconian step—a step that courts are quite reluctant to take in the absence of fraud or other extraordinary circumstances. Nor, in most cases, do creditors really want a trustee, since the case would slow to a crawl while the trustee educated herself about the debtor’s business. In most cases, the credibility of the creditors’ threat (as in all games of “chicken”) therefore depends on their confidence that the debtor’s directors are more worried about the appointment of a trustee than the creditors are.

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

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

43 Shareholders sometimes receive a limited equity interest in the reorganized company, but most of the equity goes to the company’s creditors. See, e.g., Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. PA. L. REV. 125 (1990).

44 Creditors could also object to proposed compensation for disfavored directors, or refuse to vote for confirmation of a reorganization plan that does not bring in new management. But there are obvious limitations to each of these strategies. Their objections may be rejected, and confirmation threats amount to another game of chicken—creditors will be hurt if the case drags on.
compensation arrangements.\textsuperscript{45}

One interesting and important effect of Enron, WorldCom and the other recent headline cases is that they could powerfully reinforce the norm of directorial responsiveness to creditors—and particularly to creditors’ calls for them to step down. Here’s why. Recall my statement a moment ago that courts are reluctant to appoint a trustee in the absence of fraud or gross misconduct. Although the megabankruptcies of the 1980s and early 1990s usually did not involve obvious, pervasive fraud, the most spectacular recent cases are quite different. Just tick down a list of the cases—Enron, WorldCom, Global Crossing, Adelphia. Each is saturated in fraud. As a result, creditors’ threat to call for a trustee is far more potent than in previous years,\textsuperscript{46} and it seems quite likely that these cases will color the thinking of courts and directors for years to come. If courts are more willing to appoint a trustee (or if the parties think the court would be more sympathetic to such a request), we can expect directors to listen even more closely to creditors’ demands, even in cases that do not look remotely like Enron or Global Crossing.

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

\textsuperscript{45} For a discussion of the shift in norms for directorial performance outside of bankruptcy over the past several decades, see, e.g., Melvin A. Eisenberg, \textit{Corporate Law and Social Norms}, 99 COLUM. L. REV. 1253 (1999)(emphasizing the new expectation that directors engage in meaningful oversight).

\textsuperscript{46} Enron is perhaps the best illustration. Enron’s board and its bankruptcy lawyers were rumored to have agreed to give the creditors’ committee veto power over all major decisions, due in large part to the parties’ assumption the court would quickly appoint a trustee if asked.
Given the vast number of consensual takeovers in the late 1990s, we shouldn’t draw sweeping conclusions about the extent to which staggered boards interfere with takeovers. But the effect of staggered boards on directorial acquiescence to bidders outside of bankruptcy underscores—by way of contrast—just how much bankruptcy governance has changed in recent years. A decade ago, I and other commentators analogized Chapter 11 to an antitakeover

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


49 *Id.* at 888 ff.

50 The most prominent counterexample seems to be Weyerhauser, where the board stepped down after the bidder won the initial proxy contest. *Id.* at [abt. 928].
device—a mechanism that helped managers to entrench themselves, at least for a while. The new norm in bankruptcy, by contrast, is for directors to accede to a change in control, rather than to resist.

II. THE VIRTUES OF THE NEW NEW BANKRUPTCY GOVERNANCE

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

We need only recall the concerns of the 1980s and early 1990s to appreciate the system-wide benefits of creditors’ increased influence over bankruptcy governance. No longer do we hear complaints about endless extensions of the debtor’s exclusivity period and cases that go on for ever. Nor do debtors’ managers cling to unrealistic hopes of reorganizing the firm in essentially its existing form against all the odds. The terms of the debtor’s post-petition

51 See, e.g., David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEX. L. REV. 471, 535 (1994)(“Like an antitakeover device, bankruptcy can impair the market’s ability to discipline managers because it may substitute reorganization procedures for market mechanisms that would otherwise lead to the ouster of managers outside of bankruptcy.”)
financing force it to sell assets that are worth more in a buyer’s hands. And performance-based executive compensation arrangements encourage managers to move more briskly through the Chapter 11 process. It is now in the managers’—not just creditors’—interests to reorganize as promptly as possible.

To this point, I have focused almost entirely on the ex post effects of the creditors’ new governance levers— that is, their effect once the company has encountered financial distress. But these levers have quite attractive ex ante effects as well. An important benefit of the deviations from absolute priority made possible by Chapter 11 is that they encourage managers of a troubled firm to file for bankruptcy, rather than delaying as long as possible (and destroying value as they fend off the inevitable).52 But the prospect that shareholders will receive something, even if the firm fails, gives managers and shareholders an incentive to take excessive risks while the company is healthy.53

If used effectively, the creditors’ new governance levers can preserve the ex ante benefits of deviations from absolute priority while reducing their downside. Overall, they diminish the likelihood of deviations from absolute priority by reining in the debtor’s managers. At the same time, managers know they will be paid well in Chapter 11 if creditors view them as part of the solution to the company’s woes, rather than as emblematic of its problems. The knowledge that they will be re-assessed at the outset of the bankruptcy case may make managers less anxious to take value-destroying risks while the company is still solvent. To be sure, there is a risk that


managers will respond by pursuing projects for which they are indispensable. But the existing
evidence suggests that there may be limits as to managers’ ability (or perhaps even their
inclination) to entrench themselves in this fashion.54

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

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

Chapter 11's generous treatment of DIP financing raises two closely related kinds of
concerns, both of which stem from the priority status of this interim financing. The first and
most obvious concern-- the one prior commentators have tended to emphasize-- is the possibility
that DIP financing will promote overinvestment.55 The risk of overinvestment is the dark side of
DIP financing’s principal benefit, the fact that superpriority can counteract creditors’
unwillingness to fund even desirable projects if the borrower is insolvent. Although DIP
financing makes it possible to fund positive present value projects, thus solving a debtor’s

54 For a fascinating study that finds evidence supporting of this sort in Sweden’s
automatic auction bankruptcy regime, see B. Espen Eckbo & Karin S. Thorburn, Control
Benefits and CEO Discipline in Automatic Bankruptcy Auctions (unpublished manuscript, June
2002)(on file with author).

55 The best analysis of this issue, and still the leading article on DIP financing, is George
G. Triantis, A Theory of the Regulation of Debtor-in-Possession Financing, 46 VAND. L. REV.
901 (1993).
underinvestment problems, it can also be used to fund negative present value projects, since the lender is protected by its priority status in both contexts.

The question raised by the overinvestment concern is whether courts or some other decision maker can distinguish between good DIP financing arrangements (the underinvestment context) and bad ones (overinvestment), and thus maximizing the benefits of DIP financing and controlling its costs. The principal focus here is on screening, the initial decision whether and on what terms, to authorize the DIP financing. But the growing use of DIP financing as a governance lever has underscored that the DIP lender is not simply a passive supplier of capital. This heightened prominence in major cases raises a second issue: to the extent they are calling the shots, or helping to call the shots, do DIP financers have appropriate decision making incentives during the Chapter 11 case? Let me start with the question of DIP lenders decision making during the case. I will then swoop back to consider some of the problematic terms that

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56 Although many commentators have argued that DIP financing leads to inefficient continuation of economic distressed companies– and thus, that overinvestment is a serious problem-- the empirical evidence thus far is more encouraging. Recent studies suggest that cases with DIP financing are more likely to lead to reorganization and are resolved more quickly than cases without DIP financing. See, e.g., Maria Carapeto, Does Debtor-in-Possession Financing Add Value? (unpublished manuscript, Dec. 19, 2002)(studying publicly traded companies that filed for bankruptcy during 1986-1997); Sandeep Dahiya et al, Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence (unpublished manuscript, Feb. 2001)(sample taken from all Chapter 11 cases filed from 1988-97). See also Sris Chatterjee et al, Debtor-in-Possession Financing: Management Entrenchment or Certification and Monitoring (unpublished manuscript, 1999)(finding increasing in stock and public debt value when DIP financing is approved).

57 Commentators have long been aware that banks play an important role in the insolvency context, of course. See, e.g., Stuart Gilson, Bankruptcy, Boards, Banks and Stockholders, 27 J. FIN. ECON. 355 (1990)(describing influence of banks). My point is simply that lenders have racheted up their role in large Chapter 11 cases in the past few years. For a somewhat similar perspective, see Chatterjee et al, supra note [56] (emphasizing the monitoring role played by DIP lenders, in addition to the “certification” they provide of debtor quality).
are currently being included in DIP financing agreements at the outset.

To assess DIP lenders’ role in Chapter 11 governance, it is useful to begin by contrasting today’s lenders to the investment banks that played a similarly central role in the old equity receivership era. In the early twentieth century, J.P. Morgan and Kuhn, Loeb represented shareholders and bondholders, and often emerged from the restructuring holding a chunk of the debtor’s debt and stock.58 As a result, J.P. Morgan acted more like a residual claimant of the firm’s assets than, say, Citigroup now does.59 It benefitted directly if the reorganized debtor succeeded, and suffered if the company did poorly.

Things look rather different from DIP financiers’ secure perch at the top of the priority ladder. Because they face a downside risk if the debtor’s fortunes are volatile,60 but their upside potential is fixed, DIP financiers have an incentive to minimize volatility and to compress the debtor’s risk profile. In Chapter 11, the simplest way to do this is to convert most or all of the debtor’s assets to cash through sales. It is important not to overstate the point. If the debtor’s business is truly viable, and the lender hopes to continue its lending relationship with the firm,
the desire for future business will counteract the impulse toward liquidation. If the debtor is not viable, on the other hand, liquidation may be just what the doctor ordered. On the margin, however, there is a risk that DIP lenders will put pressure on the debtor to liquidate too many assets too soon if they are calling the shots.

To the extent DIP lenders do indeed become too quick to liquidate, this impulse could not only lead to inefficient liquidation; it could also undermine a salutary effect of large scale Chapter 11 cases that I will refer to as the “antitrust benefit.” What do I mean by “antitrust benefit?” Simply this. The failure of a prominent company can often roil the competitive structure of an industry. If the industry is relatively concentrated to begin with, the disappearance of a major company might leave a small number of companies that have significant market share. In the airline industry, for instance, if United, U.S. Air and perhaps one or two of the other troubled airlines were liquidated or absorbed into their healthier peers, the industry could become increasingly monopolistic. By providing a way for existing companies to reorganize in stand alone form, Chapter 11 supplies a benefit that has received surprisingly little attention from bankruptcy commentators.61

In a world that replaced Chapter 11 with, say, mandatory auctions, the antitrust benefit could disappear. In an auction, the most likely bidders are other companies in the same industry.

61 It is important to note that even if DIP lenders had an incentive to maximize the value of the debtor, this would not give them an incentive to protect the antitrust benefit. The antitrust benefit is a positive externality created by Chapter 11-- a social benefit rather than a benefit to the firm itself.

In contrast to this positive externality, bankruptcy also produces negative externalities in at least one critical area: the rules for assumption and rejection of contracts give the debtor an incentive to reject contracts that are socially desirable. For discussion, see Alon Chaver & Jesse Fried, Managers’ Fiduciary Duty Upon the Firm’s Insolvency: Accounting for Performance Creditors, 55 VAND. L. REV. 1813 (2002).
This is not always the case, of course, but in an auction regime regulators would more frequently be faced with the decision whether to exclude industry bidders (and perhaps set the stage for piecemeal liquidation as a result), on the one hand, or to permit an industry bid that could ratchet up industry concentration.62

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

A final issue is the use of DIP financing agreements to effect a takeover of a Chapter 11 firm. While these transactions are grounds more for applause than for concern, there is a risk

62 This does not mean that Chapter 11 is all sweetness and light from the perspective of industry competition, and that alternative regimes or a world of DIP financer control would bring only darkness. Chapter 11 can have perverse effects on industry competition, as well as beneficent ones, at least in the short-run, as detractors of the WorldCom bankruptcy have been quick to point out. See, e.g., Simon London, Critics Say It Should be the End of Story for Chapter 11, [cite], Dec. 20, 2002 (quoting Verizon CEO’s complaint that WorldCom and Global Crossing can “use Chapter 11 ‘to cleans their sins, then drive prices down’”). But, on balance, Chapter 11’s emphasis on stand alone reorganization is likely to preserve industry competition.
that a takeover bidder enters the picture as a source of DIP financing will use the DIP financing agreement to effectively preclude other bidders. In these cases, the DIP financing agreement may serve not just to effect a change in control, but also to dictate its terms.63

The $64,000 question is this: just how serious are these concerns on the ground? Overall, the emergence of DIP financing agreements as a central text of Chapter 11 is a welcome advance, for all of the reasons I briefly described in the last part. But in at least some cases, the fetters are too tight; the restrictions enshrined in the DIP financing agreement will have perverse effects as the case progresses.

How might we address these downsides of the DIP financing lever? Let me suggest and critique three possible responses, starting with the most dramatic. The first option is to rethink the way corporate debtors finance their reorganization effort. As we have seen, post-petition lenders (i.e., the holders of receivers’ certificates) had very little role in corporate governance during the equity receivership era. One way to edge back in this direction, and curb the influence of DIP lenders, would be to sharply restrict the scope of DIP lending, and force the debtor to fund the reorganization through new financing (such as selling stock or debt) at the confirmation of the bankruptcy case. Most debtors seek new exit financing when they reorganize, even now, but they not infrequently look to the same lender who provided their interim DIP financing.

Although shifting the focus from commercial to investment banks would be quite attractive in some contexts, it has serious shortcomings as a general response to DIP lenders’

63 The most prominent current example is U.S. Air. As discussed earlier, see supra note [26], Retirement Systems of Alabama has negotiated for the right to appoint seven directors and for 36% of the stock of the reorganized airline. To the extent the agreement is enforceable, it will largely dictate the shape of any reorganization plan.
suboptimal decision making incentives in large Chapter 11 cases. The most important problem is simply that it would be quite difficult to stuff the genie back in the bottle. Investment bankers no longer play the active oversight role they did in the J.P. Morgan era, and commercial banking has evolved to fill in the vacuum. An additional problem is that bank borrowing often makes more sense than issuing public debt when a company emerges from bankruptcy, given the likelihood that the ownership structure of the reorganized firm will be concentrated.64

The second strategy would be to subject the DIP lending to a vote of the firm’s general creditors, since the general creditors are likely to be the party with the best decision making incentives. One way to structure the vote would be to permit the court to authorize the initial DIP financing at the outset of the case, then require creditor approval if the debtor wishes to increase the scope (either in amount or duration) of the financing arrangement.65 Although creditor voting is more realistic, it too has important downsides. Holding a vote during the early stages of a Chapter 11 case would be quite cumbersome, for instance. And if creditors could be

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

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

The creditor voting concept has received substantial attention in the sovereign debt context. See, e.g., William F. Bratton & G. Mitu Gulati, Sovereign Debt Restructuring and the Best Interest of Creditors (unpublished manuscript, 2002)(proposing creditor vote as means of facilitating interim financing. For a variation, see Patrick Bolton & David A. Skeel, Jr., Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured? (unpublished manuscript, 2003)(arguing for court approval of limited interim financing, with creditor vote required for larger loans).
expected to vote down (or force renegotiation of) a non-trivial number of DIP lending proposals, DIP lenders might be reluctant to commit to the financing ex ante.

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

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66 See, e.g., Judge Peter J. Walsh, Open Letter from Judge Peter J. Walsh to the Delaware Bankruptcy Bar re: First Day DIP Financing Orders, para.13 (April 2, 1998)(“The period of time during which the creditors’ committee should have the right to challenge the lenders’ prepetition position should generally be at least sixty days from the appointment of the committee.”)

67 If the agreement requires that a key division be sold unless it is cash flow positive within ninety days, for instance, a court might hold the DIP lender at bay if, after ninety days, the sale seemed likely to undermine the restructuring effort. But it should be noted that there is a strong presumption against undoing the terms of a DIP financing agreement. See, e.g., Bankruptcy Code section 364(e)(no appeal of court’s decision to approve financing).

68 The concern is that the added protection will facilitate borrowing to finance value-decreasing projects, such as continuation of a business that should be liquidated. For an extensive discussion, see Barry E. Adler, A Re-Examination of Near Bankruptcy Investment Incentives, 62 U. CHICAGO L. REV. 575 (1995).
collateralization provisions.\textsuperscript{69}

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

Provisions that effect a change of control by promising the lender a specified equity interest in the reorganized debt are a trickier issue. One attraction of this arrangement is that it gives the lender a direct stake in the outcome of the reorganization, thus addressing the problem of DIP lenders’ priority status. But the equity guarantee is quite similar to a stock lockup of the sort that would be unenforceable outside of bankruptcy.\textsuperscript{70} For similar reasons, the promise of a voting stake should be prohibited in bankruptcy.

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

\textsuperscript{69} Cross collateralization provisions are provisions that secure not only the lender’s postpetition loans, but also unsecured (or undersecured) advances the lender made prior to bankruptcy. The leading case on these provisions is \textit{Matter of Saybrook Manufacturing Co.}, 963 F.2d 1490 (11th Cir. 1992)(concluding that cross-collateralization is not authorized by the Bankruptcy Code).

\textsuperscript{70} See Paramount Communications Inc. v. QVC Network, 637 A.2d 34 (Del. 1994). For an extensive analysis of the appropriate treatment of lockups, both in bankruptcy and out, see David A. Skeel, Jr., \textit{Lockups and Delaware Venue in Corporate Law and Bankruptcy}, 68 U. CINN. L. REV. 1243 (2000).
to the concerns posed by existing DIP financing agreements.

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

Of the two new governance levers, the second, performance-based executive pay packages, has provoked most of the sound and fury. When Polaroid proposed a retention bonus package for forty-five executives after it filed for bankruptcy, the proposal drew such a hostile response that the debtor was forced to shelve it.71 This outrage, which also has surfaced in other recent cases, says more about perceptions than economic incentives. Indeed, in terms of incentives alone, retention bonuses are less troubling than the leverage wielded by post-petition financers. But the perception issue matters and we will need to take it into account.

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

71 See, e.g., Polaroid Withdraws $5 Million Bonus Plan to Retain Executives, WALL ST. J. [need date and page– unsigned article]. Nor is the sound and fury limited to executives who were running the company when it filed for bankruptcy. WorldCom’s proposed pay package for Michael Capellas, whom it brought over from Hewlett Packard to take the reins in the middle of the Chapter 11 case, drew sharp criticism from a district court judge who is involved in the case. See, e.g., Rebecca Blumenstein & Lingling Wei, WorldCom CEO’s Pay is Criticized, WALL ST. J., Dec. 1, 2002, at B5.
In most other countries, managers are immediately displaced when a company files for bankruptcy or insolvency proceedings, for precisely this reason. See, e.g., Armour et al, supra note [64], at 1729, 1745 (manager displacement in Germany, Japan and England).

In a moment, I will take up each of the issues-- pre-bankruptcy bonuses and performance-based bankruptcy pay-- in turn. But first, let me say a bit more about the fault-line running through these managerial pay questions, the tension between incentives and perception.

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The case for bonuses and performance-based pay is quite simple. In order to restructure a troubled company, the company must persuade its good managers to stay. These, after all, are the executives who know the business best. And to ensure that these good managers keep their eyes on the ball, they should be given performance-based incentives to achieve a prompt, efficient reorganization.

The case against these bonuses begins with the question why we should be paying lucrative bonuses to the very executives who managed to steer the company into bankruptcy. In part, this reflects the longstanding debate as to whether it is better to keep the existing managers in place because they know the business best; or to kick the bums out because they ran the company into bankruptcy. But there is a more visceral fairness concern as well. Watching the executives take their lucrative bankruptcy bonuses while ordinary employees is deeply disturbing to many-- especially other employees, many of whom have lost their jobs, pensions, or both. “It is hard to imagine,” a WorldCom employee wrote in opposition to WorldCom’s bonus plan, “that ... the efforts of [329 “key” employees] are 1600 times more valuable than all other personnel at the Company.” While the plan might “maintain [the] morale” of the favored employees, it “will in no way send a positive message to anyone” else. “Many employees are...

In most other countries, managers are immediately displaced when a company files for bankruptcy or insolvency proceedings, for precisely this reason. See, e.g., Armour et al, supra note [64], at 1729, 1745 (manager displacement in Germany, Japan and England).
necessary to implement the reorganization plan,” she reminded the court, “not just the key employees.”

Let us start by taking a closer look at the use of retention bonuses on the eve of bankruptcy. Kmart is perhaps the best recent illustration. Less than a month before

73 Objection by Julie A. Harazduk, WorldCom employee, to Motion for Authorization to Propose a Key Employee Retention Plan (Oct. 24, 2002).

74 A somewhat related compensation issue is sales of stock by executives shortly before bankruptcy. In the simplest case, the executive sells stock that she previously purchased (generally by exercising stock options) or was given by the company. Gary Winnick, the former CEO of Global Crossing, sold a whopping $500 million worth of stock in the two years before the company filed for bankruptcy. See, e.g., Andrew Hill, Barons of Bankruptcy: Part III, FIN. TIMES, Aug. 2, 2002, at 10 (Winnick compensation). For Enron’s Ken Lay, the harvest was roughly $220 million. See, e.g., Corporate America’s Woes, Continued, ECONOMIST, Nov. 26, 2002, at 60.

Prebankruptcy stock sales are much harder to defend in incentive terms than the other forms of compensation we will consider. It is not obvious that these sales are essential to retaining top managers to encouraging them to maximize shareholder value. But see Henry G. Manne, Options? Nah. Try Insider Trading, WALL ST. J., Aug. 2, 2002 (defending insider trading generally on compensation grounds, and as mechanism for providing valuable information to the market). Executive stock sales look suspiciously like preferential transfers—that is, transfers that favor one claimant over others when there are not enough assets to go around, and which have long been prohibited under American bankruptcy law. 11 U.S.C. 547 (authorizing trustee to retrieve transfers by the debtor within ninety days of bankruptcy, with a one year reachback if the transferee is an insider). To be sure, there are as many differences as similarities. Stock sales don’t deplete the company’s assets to the same extent as preferential transfers, for instance. But stock sales leave the executives better off than ordinary creditors and employees, just as a true preference would.

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

The obvious solution: simply amend the Bankruptcy Code to apply the same rules to stock sales that are applied to preferences. Executives should be forced to disgorge the proceeds of any stock sales they make within eighteen months of bankruptcy. For a similar conclusion, see Henry M. Paulson, Restoring Investor Confidence: An Agenda for Change (speech to
bankruptcy, Kmart doled out $30 million in “retention loans” to its then CEO, Charles Conaway, and several other top executives.\textsuperscript{75} Retention bonuses can be justified as the only– or at the least, as a necessary– way to persuade key managers to stay.\textsuperscript{76} This doesn’t mean that retention bonuses should simply be permitted, with no second thoughts, however. Prebankruptcy retention bonuses raise both efficiency and fairness concerns. Whether one emphasizes efficiency or fairness, the chief worry is the agency cost concern that managers will focus on their own interests rather than what’s best for the company. The company’s directors are in effect paying their own when they pay retention bonuses to top managers, and one can’t help suspecting that some will use retention bonuses as one last opportunity to ensure themselves a big payday.\textsuperscript{77}

As it turns out, existing law already provides a mechanism for challenging prebankruptcy pay packages that look more like handouts than efforts to retain key executives. Fraudulent

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76 Observers noted, for instance, that “[f]or years, Kmart had trouble making its merchandising systems work well and desperately needed to keep senior executives who oversaw those systems.” According to one expert, a “wholesale exodus would have meant ‘they’d never get any merchandise out of the stores.’” \textit{Id.}

77 For an argument that executive compensation arrangements outside of bankruptcy are more likely to reflect managerial power than optimal contracting, see Lucian A. Bebchuk et al, \textit{Managerial Power and Rent Extraction in the Design of Executive Compensation}, 69 U. CHI. L. REV. 751 (2002).
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conveyance law authorizes the bankruptcy court to reverse a transfer made by an insolvent debtor, if the debtor did not receive “reasonably equivalent” value in exchange.\textsuperscript{78} If I sell my house to my sister for $1 before filing for bankruptcy, the transaction will be voided as a fraudulent conveyance. Although the facts are more subtle, one can make the same kind of argument about excessively generous prebankruptcy retention bonuses. Fraudulent conveyance scrutiny has an unavoidably impressionistic quality. Given the benefits of a well-designed retention bonus plan, this ad hoc approach is preferable to per se prohibition, but it also forces us to consider how a judge can determine whether she is looking at an admirable plan or a disguised handout. One factor that courts should consider is whether the plan gives the executive a direct incentive to stay. A plan that conditions some or all of its benefits on the executive continuing in her post is more defensible than an immediate cash payment, as is a plan that includes performance based incentives.\textsuperscript{79} The court should also consider the magnitude of the bonus in comparison to previous bonuses and the executive’s overall pay, as well as to compensation levels in other, comparable companies.\textsuperscript{80}

\textsuperscript{78} 11 U.S.C. section 548. The bankruptcy trustee can also use state fraudulent conveyance provisions such as those based on the Uniform Fraudulent Transfer Act. The trustee’s power to do this comes from 11 U.S.C. section 544(b), which authorizes the trustee to invoke any nonbankruptcy law that one of the debtor’s unsecured creditors could have invoked outside of bankruptcy. There is relatively little substantive difference between section 548 and the UFTA. The principal distinction is that the UFTA provides a longer statute of limitations.

\textsuperscript{79} Kmart’s “retention loans” introduce another twist on this theme. Both the loan itself (if it appears that Kmart had no intention of requiring repayment) and the company’s subsequent decision to forgive the loan can be challenged on fraudulent conveyance grounds. The case for disgorgement is strongest if, as with some of the Kmart loans, the loan is forgiven without any obligation for the employee to remain at the company.

\textsuperscript{80} Outside of bankruptcy, compensation arrangements can also be challenged on fiduciary duty grounds. Delaware courts have traditionally shown a great deal of deference to compensation arrangements that are approved by a disinterested committee of directors. \textit{See,}
Turn now to retention bonuses that are put in place after the company files for bankruptcy. Post-petition pay packages raise the same kinds of concerns as pre-bankruptcy bonuses, but with some very important differences. The key distinction is that the directors cannot unilaterally implement a bonus program once the company has filed for bankruptcy. The program must be presented to the bankruptcy court for approval. This means that creditors have the right to file formal objections; and, in practice, creditors weigh in long before the formal hearing. As a result, there is much less reason to worry that managers are helping themselves at the expense of the business than there is with prebankruptcy compensation plans.  

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

What does this mean for judicial oversight of bankruptcy bonus plans? The short answer is that courts should not simply rubberstamp any proposed plan, but there should be a much stronger presumption of approval than with prebankruptcy bonus packages. The presumption

e.g., Lewis v. Vogelstein, 699 A.2d 327 (Del Chan. 1997). But Delaware’s judges have hinted that they plan to scrutinize these arrangements more closely on the future. This suggests that fiduciary duty is an alternative line of attack that could be invoked in bankruptcy.

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

should be especially strong if most or all of the company’s creditors support the plan.83

This does not mean that the current post-petition pay arrangements are optimal, of course-- only that they are likely to be superior to straight cash compensation. Let me conclude by taking a closer look at the existing arrangements and possible alternatives to them.

The first generation of pay-for-performance contracts-- the contracts we are seeing now-- have tended to tie managers’ performance bonuses to the speed of the case. Although speed is likely to correlate fairly closely with the goal of maximizing the value of the debtor’s assets, one certainly can imagine other approaches. Is there a different measure that would more closely link managers’ effectiveness to their bankruptcy pay? Two possible alternatives come to mind. The first, and most precise measure, would be to based the managers’ pay on the overall value of the debtor’s assets at the conclusion of the Chapter 11 case. Tying the managers’ pay to the debtor’s value would give them a strong incentive to take whatever steps were necessary to maximize value, whether this meant a quick reorganization case or a longer, more thorough process. This strategy works nicely if the company is being liquidated. In a reorganization, by contrast, the difficulty of assessing the overall value of the debtor’s assets poses obvious

83 What if the bonus package provokes outrage shortly after it is approved? Once again, the court should take its cues from the debtor’s managers and-- most importantly-- from the company’s creditors. If the perception of unfairness is likely to seriously undermine employee morale, we can expect the creditors to join the call to revisit the terms of the compensation plan. Rather than interfering with managerial compensation, a more sensible response to employees’ unhappiness with many of the bonus plans would be to adjust the too stingy treatment of employees’ own claims in bankruptcy. In several of the most high profile cases, courts have taken matters into their own hands. Under the Bankruptcy Code, employees are entitled to priority treatment for up to $4,650 in prebankruptcy wages. 11 U.S.C. section 507(a). In WorldCom, Judge Gonzalez ignored this limitation, and approved the payment of full benefits for thousands of WorldCom employees who lost their jobs. See, e.g., Shawn Young & Jared Sandberg, WorldCom Can Pay Full Severance, WALL ST. J., Oct. 2, 2002, at B4.
problems. To be sure, the debtor provides a valuation when it files a reorganization plan. But the plan proponent’s valuation functions more as an advocacy document, as a brief in support of the proposed plan, than as an objective valuation.

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

So why haven’t managers been offered post-reorganization stock? There may be some question whether the court can set aside “when issued” stock, but this doesn’t explain why stock-based pay packages are rarely proposed. The possibility that the company may be liquidated rather than reorganized is similarly incomplete. A substantial majority of the largest

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84 See, e.g., Bebchuk et al, supra note [77], at 796-802 (stock-based option plans rarely attempt to screen out price changes that have no connection to the executives’ performance).

85 Nothing in the Bankruptcy Code explicitly prohibits the use of when-issued stock as compensation, but some bankruptcy lawyers worry that this strategy would interfere with the reorganization process, and might therefore be struck down as a “sub rosa” reorganization plan.
corporate debtors do in fact reorganize, and the compensation plan could be adjusted to provide for cash compensation in the event of a liquidation. The most likely reason that stock-based compensation is seldom considered is that managers like the greater certainty of cash-based performance pay; creditors much prefer that executive pay be linked to speed; and both would therefore resist a stock-based approach. The best normative defense of this aversion to stock-based pay is that it could have a troubling effect on managers’ incentives in at least a few cases. Managers might threaten to destroy value, or actually destroy value, in order to coerce creditors to accept a draconian “haircut,” for instance.86 There is also a less benign explanation as to why creditors haven’t clamored for stock-based pay, however: creditors would much rather have managers focus on speed, since this diminishes the managers’ incentives to play hardball with respect to the haircut creditors are expected to take.

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

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

Bankruptcy isn’t exactly a place one expects to see the Coase theorem in action. Bankruptcy is full of intricate regulation and judicial intervention. Yet, to a remarkable extent, creditors have responded to the complaints of the past two decades in precisely the way Coase might predict. Stung in the 1980s by managers’ tendency to drag out the Chapter 11 case, creditors have used postpetition lending agreements and managerial compensation contracts to reshape corporate governance in Chapter 11. Cases now move faster, and managers spend much more time overseeing merger and acquisition activity than caballing in smokey backrooms.87

Corrections never lead us back to a mythological Archimedean point, of course. Adjustments bring their own problems, their own characteristic flaws. Much of our discussion has focused on the dangers of the two new governance levers. With DIP financing agreements, we saw that DIP financers may use the interim financing agreement to improve the status of their prebankruptcy loans, and the lenders’ priority could give them too great a bias toward liquidation on the margin. Rather than making structural changes to counteract this bias, the best solution is simply for courts to restrict the provisions they will permit in a DIP financing agreement, particularly when the debtor obtains DIP financing from an existing lender. With managerial compensation, courts should sharply distinguish compensation agreements that came before bankruptcy from those that are proposed during the bankruptcy case. Prebankruptcy bonuses are

87 Creditors’ response to concerns about Chapter 11 parallels in intriguing respects the increased use of incentive-based compensation outside of bankruptcy after Delaware upheld the use of poison pills. Incentive-based compensation seems to have diminished managers’ hostility to takeover bids. See Marcel Kahan & Edward B. Rock, How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law, 69 U. CHI. L. REV. 871 (2002).
far more likely to reflect managerial self-dealing and should be scrutinized on fraudulent conveyance grounds. Post-petition compensation, on the other hand, is subject to significant creditor oversight. Creditor support is a good indicator that the program will have a beneficial effect on Chapter 11 governance and should be approved.

Ex post contracts are a second best solution to the risk that managers will destroy value in Chapter 11 by pursuing their own private interests, rather than maximizing overall firm or social value. A bankruptcy contract that addressed these issues in advance—by giving managers an incentive to pursue liquidation rather than a reorganization, for instance, if this were efficient—might be preferable in theory. And I wholeheartedly agree with the commentators who have suggested that corporate debtors should be permitted to devise their own bankruptcy rules, and to opt out of bankruptcy, if they so choose. But ex ante contracting has its own downsides, and the most important comparison for present purposes is the comparison between current bankruptcy practice and Chapter 11 in the Eastern Airlines era, circa 1990.

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


89 The most obvious difficulties with tailored, ex ante bankruptcy contracts are issues of implementation, such as the question of how to effectively alter the contract when the company’s fortunes or economic conditions change.
Chapter 11 from a takeover defense to what, at the moment, is our most vibrant market for corporate control.