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THE SEARCH FOR HERCULES: RESIDUAL OWNERS, DIRECTORS, AND CORPORATE GOVERNANCE IN CHAPTER 11

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The Myth of the Residual Owner[1] is vintage Lynn LoPucki. Befitting the leading empirical scholar on the Chapter 11 proceedings of large, publicly held companies, the piece rigorously exposes under-appreciated aspects of modern Chapter 11 practice. *Myth* enriches our understanding of reorganization practice by replacing the standard characterization of a business's capital structure as consisting of secured debt, unsecured debt, and equity with a pattern that reveals a more complex priority structure.[2] Rather than a single class of unsecured creditors lodged firmly between secured creditors on the top and equity holders on the bottom, LoPucki finds a plethora of classes, with a median number above three and some businesses having as many as thirteen.[3]

Which classes actually see money at the end of the day is more important than how many classes are seeking funds. A central function of a bankruptcy proceeding is dividing up the pie. The number of priority classes, just like the number of claims, provides an incomplete and often misleading picture of the reorganization process. What matters is money. LoPucki enlightens us along this dimension as well. In most cases, at least the most senior group of unsecured creditors is paid in full.[4] They get what they contracted for. More surprisingly, however, is that there is often more than one group that gets partial payment. In over half of the cases in his sample, two or more groups of unsecured creditors received partial payment.[5]

These results are interesting in and of themselves. LoPucki's data demonstrate that priority need not be tied to the institution of secured credit; contracts that establish priority are quite effective.[6] In some cases,

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* Professor of Law, Vanderbilt Law School. The thoughts in this response grow out of my long, fruitful, and continuing collaboration with my colleague Douglas Baird. I would like to thank Lynn LoPucki for his generous sharing of his data, his sharing of his time as I worked with his database, and his comments on an earlier draft of this response.

1. Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341 (2005).
2. *Id*. at 1356.
3. *Id*.
4. *Id*. at 1363 n.69.
5. *Id*. at 1361.
6. *Id*. at 1353.

one group may hold investments that are expressly subordinated to other investments. In other cases, lenders can create priority among unsecured debt through careful attention to which entities incur which debts. The fact that corporate structure can itself create priority is one that is too often overlooked in bankruptcy scholarship.[7] If anything, LoPucki understates the extent to which structural priority occurs in modern lending markets.

LoPucki, however, is not content with only making an empirical observation. In addition, he seeks to use these findings to construct a case for a particular governance structure for the enterprise while it is in Chapter 11.[8] LoPucki undertook his search for the residual owner in an attempt to shake the faith of those who believe that the fate of financially distressed firms is best determined by those with their money on the line.[9] In leveling his attack, however, LoPucki outruns his data and rests on assumptions that find little support in today's Chapter 11 process.

LoPucki reasons that since there are multiple levels of priority, creditors have conflicting interests that prevent them from steering the distressed business.[10] Their opposing desires can be best mediated by the bankruptcy court and the board of directors. Chapter 11 "provides the only form of governance practical in the circumstances: a benevolent dictatorship of the board as fiduciary and the bankruptcy judge as referee."[11]

This analysis falters on fact and on theory. As to fact, *Myth* errs in positing that the board of directors of the bankrupt corporation navigates the enterprise through Chapter 11 guided only by its business judgment.[12] LoPucki offers scant detail on his view of what decisions are made in today's Chapter 11 and which players influence these decisions. He mentions "investment policy" repeatedly, but does not focus on what investment choices are available. He talks about "managers" of the debtor, which presumably includes the corporation's officers and directors, but tells us little about to whom they owe allegiance. In fact, directors today have little freedom to do as they see fit when the corporation becomes

7. The importance of corporate groups is an under-explored aspect of reorganization practice.

8. *Id*. at 1361–64.

9. *Id*. at 1342.

10. *Id*. at 1344–45.

11. *Id*. at 1369. Curiously, while LoPucki extols the virtues of the current regime in this paper, in other work and before Congress he has excoriated the same system as being "corrupt." *See, e.g.*, *Testimony: Court Competition for Large Ch. 11 Cases*, 23 AM. BANKR. INST. J. 53 (2004), WL 23-SEP AMBKR1J 6 (excerpts of LoPucki's testimony before Congress); LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2005).

12. LoPucki, *supra* note 1, at 1368.

financially vulnerable. Creditors focus unblinkingly on control, and they ensure that their interests are at the fore. The method of control may differ from case to case, but the overall theme of corporate reorganizations now is that senior creditors can ensure that they have the final say over decisions that have the potential of adversely affecting their interests.[13] This change in the locus of control has been accompanied by a change in the primary decision that dominates most Chapter 11 cases—whether or not to sell the business as a whole. The directors may be the ones who ultimately vote to auction the business to the highest bidder, but their votes are usually guided by the wishes of the senior lenders. We should not romanticize directors as the platonic guardians of the corporation.

As to theory, *Myth* exaggerates the conflicts among creditors because it fails to take account of the fact that priority structure is changed radically during the bankruptcy proceeding. Setting to one side the cases where the enterprise is sold, and hence there is no issue about governing the enterprise after Chapter 11, we do not see the type of conflicts that LoPucki posits among residual claimants in negotiations. At the end of the case, debt contracts are cancelled and the number of entities that comprise the debtor is dramatically reduced. The erstwhile debt holders often receive the bulk of their payment in common stock in the newly reorganized corporation. As such, their views on the investment policy the business should follow while in bankruptcy will reflect the interest that they will possess when the enterprise leaves bankruptcy rather than the interest that they held at the start of the case. The senior creditor will often retain control by receiving a majority of the shares of the reorganization company. Regardless of how the shares are distributed, the ability to convert debt into equity creates an incentive for the various priority levels to maximize the value of the new shares on a going-forward basis.

This is not to say that negotiations among debtholders are not fierce. They are, even between creditors with control and those without it. But what is often at stake is not an issue of the course that the business should take once it exits Chapter 11; it is an issue of allocating interests in the reorganized entity. Valuation is often contested. The parties thus need to assign a value to the enterprise. The range of plausible valuations, however, implies a range of distributions across priority groups. Changes in valuation will change the amount of stock each group receives in the

13. For an extended account of corporate governance both before and during bankruptcy, see Douglas Baird & Robert K. Rasmussen, When Good Managers Go Bad: Controlling Agents of Enterprise (2005) (unpublished manuscript, on file with author).

reorganized entity. It does not, however, change the interest of each group to maximize the value of the business.

Structural priority creates even more room for negotiation. Not only must a value for the entire operation be determined, but the constituent parts need to be assigned values as well. In addition, substantive consolidation, which has the effect of undoing structural priority, can be threatened by those who would see the value of their holdings increased by lumping all assets and all claims in one pot. Such issues, however, do not implicate matters of corporate governance while the enterprise is in Chapter 11. In short, parties fight over the allocation of the pie. What they do not do, however, is fight over how to increase the size of the pie.[14]

The investors in control protect their interests through the normal corporate governance structure. They ensure that the directors and the management team have their confidence. Turnover here is common. To the extent that operational issues need to be addressed, those in control ensure that the necessary changes are made. One should not look to the extant directors and the judge as the Hercules[15] of the bankruptcy process.

I. THE ROLE OF THE RESIDUAL OWNER

Control rights have become the central focus in recent bankruptcy scholarship.[16] This focus has both a positive and a normative dimension. On the positive side, the challenge is to understand how these rights are

14. More precisely, they do not pursue differing strategies based on differing claims on the future cash flows of the business. Even if parties share the same interest in maximizing the overall value of the business, they may disagree on which strategy offers the best course for achieving this result.

15. *See* RONALD DWORKIN, TAKING RIGHTS SERIOUSLY 105–06 (1977) (referring to the Hercules, and describing him as "a lawyer and judge of superhuman skill, learning, patience, and acumen.").

16. Douglas Baird and I have explored the importance of control rights in a series of articles. *See* Baird & Rasmussen, *supra* note 13; Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003) [hereinafter *Twilight*]; Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) [hereinafter *The End of Bankruptcy*]; Douglas G. Baird & Robert K. Rasmussen, *The Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787 (2002); Robert K. Rasmussen, *Secured Credit, Control Rights and Options*, 25 CARDOZO L. REV. 1935 (2004). We are by no means alone in this emphasis. *See, e.g.*, David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 PA. L. REV. 917 (2003); Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 51 (2003), WL 22-SEP AMBRK1J 12; Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004); Harvey R. Miller & Shai Y. Waisman, The Erosion of Debtor Protections in the Face of Expanding Creditors' Rights and Controls (Sept. 2, 2003) (unpublished manuscript, on file with author) (presented at Lawrence P. King and Charles Seligson Workshop on Bankruptcy and Business Reorganization, New York University).

currently allocated. There is widespread agreement that creditors, especially senior creditors, exercise much control in modern reorganization practice.[17] On the normative side, the question centers on how control rights should be parceled out. LoPucki's primary target is the proposition that bankruptcy law should seek to vest control rights in the residual owner.[18] He seeks to show that it is difficult, if not impossible, to identify a single residual owner class in most bankruptcy cases.[19] The only feasible governance scheme is thus one that vests control rights in the board of directors, subject to the loose supervision of the bankruptcy judge.

Before assessing the validity of this argument, one must delineate what the fight is all about. There is no dispute as to where law places the *legal* authority to run a corporation; it is in the corporation's board of directors.[20] By definition, the authority to act on behalf of the corporation rests, in the first instance, with the board of directors. This is the essence of the corporate form.[21] The board can, of course, devolve this authority on others, for example, by giving officers the authority to run the corporation on a day-to-day basis, or by signing a contract that constrains its future action.

What is interesting is how this power is exercised. Corporate law generally vests the power to elect and remove directors in the corporation's shareholders. Much of the debate in the general corporate governance literature centers on the extent to which boards do or should maximize the value of the business by attempting to maximize the value of the corporation's stock.[22] Once the goal of corporate law is set, attention turns to honing the levers of corporate governance. These tools include the market for corporate control, the voting rights of shareholders, the independence of the board of directors from the CEO, and the structure and amount of the CEO's compensation contract. Some would adjust these

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17. *See generally supra* note 16.

18. LoPucki, *supra* note 1, at 1342.

19. *Id*.

20. *See* DEL. CODE ANN. tit. 8, § 141(a) (2001).

21. The five basic legal characteristics of a corporation are legal personality, limited liability, transferable shares, delegated management presided over by a board of directors, and investor ownership. *See* Henry Hansmann & Reinier Kraakman, *What is Corporate Law*, *in* THE ANATOMY OF CORPORATE LAW 1–15 (Reinier Kraakman et al. eds., 2004).

22. The standard account for shareholder maximization is that it increases the value of the corporation because all others, including the employees who contribute their human capital and consumers who buy from the corporation, can protect themselves via contract. *See id.* at 17–19. For a critique of the shareholder maximization norm, see Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

mechanisms so as to align the interests of the CEO with those of the shareholders; others, while including the interests of shareholders, would add the interests of other contributors to the corporation, such as workers.

Creditors, however, often enter into contracts that give them leverage with the board when the corporation stumbles. It is these contracts, not an ill-defined legal mandate to maximize the value of the enterprise, that often determine how control rights are exercised in Chapter 11. In a common scenario, there is a senior creditor that has extensive control. The board may be required to obtain the lender's blessing before it engages in a major transaction; indeed, it may need such approval to file a plan of reorganization. Alternatively, the senior creditor may ensure that those running the business and making the major decisions are those in whom it has complete confidence. For example, concurrent with its filing for Chapter 11, Interstate Bakeries—the maker of Wonder Bread and Twinkies—replaced its long-time CEO with a turn-around specialist who often works with lenders.[23] The bankruptcy financing for Interstate was expressly conditioned on his remaining in place.[24] Managers such as this are not "benevolent dictators" seeking to advance the interests of all stakeholders. Any discussion of bankruptcy governance needs to start from this reality.

The residual owner concept—LoPucki's target in *Myth*—is a metric used to assess the structure of governance rights in corporations.[25] The focus on the residual owner stems from agency costs. Such costs arise when ownership and control are separated.[26] The directors and officers are managers, not owners. Hence, their fate is not tied directly to the well-being of the corporation as a whole. They may take actions that increase their security and enhance their own welfare, even though such actions may decrease the overall value of the enterprise. Owners, by contrast, are those who have their own money on the table. Their pocketbooks guide

23. The specialist was Tony Alverez. *See* Jessica Wohl, *Interstate Bakeries Files for Bankruptcy*, *at* http://biz.yahoo.com/rbl040922/food_interstate_6.html (last visited Sept. 22, 2004). Baird and I discuss Alverez and his involvement in the Interstate Bakeries' bankruptcy in *When Good Managers Go Bad: Controlling Agents of Enterprise*. *See* Baird & Rasmussen, *supra* note 13.

24. Motion for Post-Petition Financing, Exhibit C, Debtor in Possession's Affirmative Covenant (o), *In re* Interstate Bakeries Corporation, 04-45814-jwv-11 (Bankr. W.D. Mo. Sept. 22, 2004), *available at* www.kccllc.net/ImpdateDocs.asp?FDM=First+ Day+Motions%D=276 (last visited April 1, 2005).

25. This concept is used extensively in corporate law generally. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67–70 (1991); Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure*, *in* THE ANATOMY OF CORPORATE LAW, *supra* note 21, at 33–34.

26. This is the theme of the classic work by Berle and Means. *See* ADLOF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

their actions. In *Myth*, LoPucki implies that only residual owners have their money on the line.[27] Such is not the case. Simply because an investor does not have residual status with regards to certain decisions in Chapter 11 does not imply that they are indifferent to the fate of the firm. As explained below, senior debt often receives equity in a reorganization. As potential future equity holders, senior creditors have their money on the line.

Investors thus seek to maximize their return on their investments. A sole owner, one who owned the business in full, would have her incentives perfectly aligned with that of the business.[28] She may hire corrupt or incompetent folks to run the business, but such decisions would be made out of ineptitude rather than induced by the capital structure of the corporation. Once investors hold different instruments, additional agency costs arise. When investors have differing claims on the cash flows of the corporation, it becomes possible for a corporation to take actions that would increase the value of one set of investments but actually decrease the value of the corporation.[29]

Such a scenario exists where the decision-maker does not bear all of the costs and benefits of that decision. For many decisions, it may well be that the class of claimants at the end of the line, the class that will get paid only if all others are paid first, may be positioned just as well as the sole owner. Many decisions affect only the fortunes of the common stockholder. Hence, in healthy corporations, shareholders as residual claimants are good proxies for a sole owner. This, at least in part, is the justification for the proposition that boards should seek to maximize shareholder wealth.[30]

Things become more complicated as the corporation nears insolvency. More and more decisions impact the expected recovery of the holders of other investment contracts. As shareholders see the costs of decisions

27. Lopucki, *supra* note 1, at 1342.

28. This alignment of incentives applies at least as a first approximation. Risk aversion—the desire not to see one's total worth decrease substantially—may induce even a sole owner to eschew strategies that have a positive expected value coupled with a large variance. Also, once the enterprise becomes large enough, the sole owner may focus on other matters such as maintaining the company's visibility rather than increasing the value of holdings that already provide her with more than she will ever need.

29. The classic paper here remains Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

30. Current debates in corporate law scholarship often center on the extent to which alternative structures can ensure that those in charge in fact attempt to maximize shareholder value. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2002); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Blair & Stout, *supra* note 22.

falling on others while the gains largely accrue to them, their incentives diverge further and further from that of the corporation as a whole. When the corporation becomes insolvent, the shareholders' gaze narrows to only the future benefits. They look for gambles that put them back in the black regardless of their costs. At this point, they are playing with the house's money.

Early academic forays into the governance of a corporation in Chapter 11 sought to wrest control from shareholders. The operating assumption was that the managers and directors in charge of the business remained loyal to shareholders.[31] Non-bankruptcy law imposes fiduciary duties on directors that benefit shareholders.[32] The fear was that managers and directors that strictly discharged such duties would pursue investment policies that were not in the best interest of the business as a whole. The rhetoric was to shift the duty so that managers and directors no longer owed fealty to shareholders who were out of the money.[33] The Delaware Chancery Court gave support to such notions, suggesting that in the vicinity of insolvency, directors and officers owe a duty to the business as a whole.

Academics also argued that shareholders should forfeit the right they have in general corporate law to call a special meeting and replace the directors. The fear was that shareholders would install apparatchiks with undivided loyalty to shareholder interests.[34] Here the case law required bankruptcy courts to determine whether to enjoin shareholder meetings on a case-by-case basis.

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31. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 673 (1993) ("Perhaps because there is a well-developed body of theory that purports to demonstrate that the managers of solvent companies will act in the shareholders' best interests, most theorists simply assume that the same is true for insolvent and reorganizing companies.").

32. *See* EASTERBROOK & FISCHEL, *supra* note 25.

33. *See* LoPucki & Whitford, *supra* note 31, at 768–71; Mark J. Roe, *Bankruptcy and Debt: A New Model of Corporate Reorganization*, 83 COLUM. L. REV. 527, 583 (1983); David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 505–13 (1992); *see also* Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1841–44 (2002) (arguing that managers should have a fiduciary duty to maximize the total value of all claims against an insolvent corporation). *But see* Laura Linn, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1495–1510 (1993) (arguing that duty should run to shareholders but that creditors be allowed to contract around that duty).

34. *See* Skeel, *supra* note 33 (arguing that shareholders should not have the right to call a meeting and replace the directors after a corporation has filed for Chapter 11); *see also* LoPucki & Whitford, *supra* note 31; Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625, 625–28 (1991) (arguing that the rights of shareholders in an insolvent corporation in Chapter 11 should be extinguished early in the proceeding).

Along the same lines, bankruptcy scholars did not trust those at the other end of the priority ladder. Those who stood to be paid in full—usually secured creditors with collateral that exceeded their debts—would be too timid. They had nowhere to go but down. The fear of loss would lead them to risk little, even if such risks would, on an expected basis, increase the value of the corporation. Hence, the proceeding was to be run for the benefit of the residual claimant.

This insight could be deployed in two ways. One is as a yardstick. We ascertain which group or groups are in control of the process and then compare their incentives to that of a residual owner (or, in an even better metric, that of a sole owner). The more those in control have incentives that depart from maximizing the overall value of the business, the more we look for alternative arrangements. While the efficacy of corporate law's duty of care is a matter of some dispute, at least it should be articulated so that it draws the attention of directors and officers to the residual claimant and away from the shareholders. When comparing differing arrangements, we ask which one is more likely to lead to results that maximize the value of the enterprise. LoPucki apparently has no quarrel with this method of analysis.[35]

A second use of the residual owner concept is more direct. It would attempt by law to vest control rights directly in the residual claimants.[36] It is this use of the residual owner standard that is LoPucki's focus here.[37] He maintains that, as a factual proposition, it is difficult to ascertain which priority level or indeed levels will have the status of residual owner.[38] One cannot devolve power on those one cannot identify.

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35. When Baird and I have invoked the notions of residual owners and sole owners in our other work, it has been in this spirit. Part of our project is to ascertain how governance decisions are made in financially distressed businesses, and ask whether the changes that we document increase social welfare. *See, e.g.*, Baird & Rasmussen, *Twilight*, *supra* note 16, at 699 ("We see that fundamental forces at work in the economy have made traditional reorganization increasingly obsolete"); Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 16, at 788 ("Chapter 11 can play its traditional role only in environments in which specialized assets exist, where those assets must remain in a particular firm, where control rights are badly allocated, and where going-concern sales are not possible. Our primary focus here has shown that large corporations no longer fit this paradigm."); Rasmussen, *supra* note 16, at 1948 ("whether or not the lender's incentives tend to maximize the value of the business is thus an empirical question that may differ across corporations").

36. To capture the difference between these two uses, consider the replacement of the board of directors during a Chapter 11 bankruptcy. The first use would counsel against allowing shareholders to call a meeting to install directors that will vigorously attempt to maximize shareholder value. The interests of the shareholders are out of whack with the interests of the residual claimants. *See* LoPucki & Whitford, *supra* note 31, at 768–71; Skeel, *supra* note 33, at 505–13. The second use would be to argue that, as an affirmative matter, the law should vest the replacement power in the creditors.

37. LoPucki, *supra* note 1, at 1342.

38. *Id.*

II. LOPUCKI'S DATA

LoPucki has painstakingly compiled a database that includes every Chapter 11 filing by a large, publicly-held corporation since the Bankruptcy Code took effect.[39] He has used it repeatedly to generate novel observations, and has generously shared it with others.[40] For *Myth*, he used corporations that emerged from bankruptcy between the start of 1991 and the end of 1996.[41] According to LoPucki's database, 159 cases ended during this period.[42] Thirty-five of these cases ended without a company emerging from the proceeding.[43] Of the remaining 124 cases, 102 filed a 10-K in the following year.[44] In other words, almost two-thirds of the corporations in LoPucki's sample exited Chapter 11 as publicly held companies. Of these, LoPucki was able to glean the number of existing priority classes in 84 cases, and he was able to obtain information on the distribution to these classes in 78 cases.[45]

Before summarizing LoPucki's findings, one further refinement is in order, and that is removing prearranged plans of reorganization from the cases of emerging corporations that subsequently filed a 10-K. In a prearranged plan of reorganization, the contours of the plan are agreed upon prior to the bankruptcy filing. Once the basic arrangement is set, the case is filed and the plan is voted on and implemented in a relatively short time. For the cases in the years that LoPucki examines, the mean number of days in Chapter 11 for prearranged bankruptcies is 79, with the median being 45.[46] This compares with a mean of 718 days (558 median) for the other cases disposed of between 1991 and 1996.[47]

In these fast-moving prearranged cases, few operational decisions need to be made while the corporation is in Chapter 11. To the extent that major changes are afoot, they will be made either before or after the Chapter 11 proceeding, but not during it. To the extent that a quest for residual owners

39. *See* LOPUCKI, *supra* note 11, at ix.

40. Indeed, he wants others to use it so that they can point out inadvertent but inevitable errors that creep into a project of this scope. *See* Bankruptcy Research Database: Frequently Asked Questions, *at* http://lopucki.law.ucla.edu/ frequently_asked_questions.htm (last visited Feb. 1, 2005).

41. *See* LoPucki, *supra* note 1, at 1350.

42. *See* Lynn M. LoPucki, *WebBRD: Lynn M. LoPucki's Bankruptcy Database*, *at* http://lopucki.law.ucla.edu/contents_of_the_webbrd.htm (last visited Jan. 27, 2005).

43. *See id*.

44. *See id*. Filing a 10-K is probably a good proxy for the corporation being publicly held. Corporations with more than $10 million in assets and 500 shareholders must file a 10-K.

45. *See id*.

46. *See id*.

47. *See id*.

is at bottom part of an inquiry into optimal governance rules in Chapter 11, prearranged cases are not a particularly useful place to look.

Of the 84 cases for which LoPucki can ascertain the number of priority levels that existed below secured debt, 30 were prearranged cases.[48] Of the remaining 54 cases, the median number of priority levels (which includes equity interests) remains 4, and mean decreases slightly to 4.2.[49] Of the 15 cases where LoPucki could ascertain that multiple levels of priority were created by the issuance of debt by different entities, only two were prearranged.[50]

Of the 78 cases for which LoPucki has data on distribution in addition to priority levels, 26 are prearranged cases.[51] Removing these cases slightly reduces the number of firms having one or two priority classes having residual owner status.[52] Replicating LoPucki's Table 1, which reports on the number of priority levels that enjoy residual claimant status at the completion of the case, with the prearranged cases removed, we get[53]:

Number of investor priority levels sharing residual owner status	Number of firms	Percent of firms
1	18	35%
2	16	31%
3	9	17%
4	5	10%
5	2	4%
Over 5	2	4%
Total	52	100%

48. *See id*.
49. *See id*.
50. *See id*. LoPucki's calculation as to the extent to which priority is created via corporate structure rather than through covenants in debt contracts may well understate the incidence of structural priority. LoPucki did not examine the prebankruptcy capital structure of the corporate groups in his sample. Rather, he looked at plans of reorganization and counted an enterprise as having structural priority only if the plan indicated that different entities in the corporate group had issued debt separately. Thus, the most we can say is that LoPucki's figure of 17% for businesses in his sample with structural priority is a lower bound.
51. *See id*.
52. *See id*. One plausible interpretation of this result is that it is easier to negotiate a new capital structure outside of bankruptcy when there are fewer levels of residual claimants.
53. LoPucki, *supra* note 1, at 1360.

Empirically, LoPucki's data establishes that large corporate groups tend to create multiple levels of priority for their unsecured debt.[54] It also establishes that when it comes to distributions, in roughly two-thirds of the cases there are more than one priority level of unsecured debt that receives some distribution but is not paid in full.[55]

III. BANKRUPTCY GOVERNANCE

LoPucki's finding of multiple priority classes, of which more than one often stands to benefit from a marginal increase in the value of the enterprise, leads to his normative conclusion. He asserts, quite plausibly, that it is usually difficult at the start of the case to ascertain with certainty which group (or indeed groups) of claimants will turn out to be the residual class.[56] Hence, he argues, governance should be left with the existing directors and managers, operating the business under the auspices of the bankruptcy court.[57]

At one level, this prescription is banal. The power to manage a corporation is vested in its board of directors, and nothing in the Bankruptcy Code divests the board of this authority. In every large enterprise, the board delegates to officers the task of running the business, reserving for itself the authority to pass on extraordinary matters. For LoPucki's tonic to have bite, he must mean something more than lodging formal power in whomever happens to occupy the boardroom and executive suite. What I believe he means is that the directors and officers in place at the time that bankruptcy is filed must be allowed to exercise their best judgment without undue influence by any investor group, be it secured creditors, unsecured creditors, shareholders, or employees.[58]

As noted earlier, this contrasts with the way in which most cases progress today. Senior creditors dominate the landscape in a way that they did not a decade ago. My sense is that LoPucki would return us to the halcyon days of old where various stakeholders all had input in the process. Regardless of whether one can ever go back, or even if one could, whether it would have its desired effect,[59] LoPucki needs to establish that

54. *Id*. at 1356.

55. *Id*. at 1359.

56. *Id*. at 1345. LoPucki implicitly assumes that differing claims are held by different entities. The extent to which this is true is unclear. A vibrant market exists for claims in large bankruptcy cases. It may well be that a single entity ends up holding different claims in a Chapter 11 case.

57. *Id*. at 1369.

58. Of course, one still needs to supply a definition for "undue."

59. *See generally* W.W. JACOBS, THE MONKEY'S PAW: A STORY IN THREE SCENES (1937).

his vision of corporate governance promises better results than does the extant process. The data that he offers in *Myth* does not carry the burden.

In evaluating this proposition, I first highlight how the decisions at the fore of modern bankruptcy practice today differ from those that dominated during the period that LoPucki studied. When we focus on these decisions, his data provides no evidence that control rights could be allocated in a manner that better advances social welfare. Investment decisions now are made by the senior lenders.[60] *Myth* offers no data that suggests that these creditors are systematically inclined to make suboptimal decisions as compared with other potential decision makers. Even disregarding issues of control, to the extent that the residual claimants he finds have conflicts, they will not lead to the conflicts over investment policies that he supposes. The point is not that the current system is by any means perfect.[61] We live in a world where optimal results are often elusive. The best we can do is compare feasible alternatives. In doing so, we seek to determine the extent to which the decisions approximate those that would have been made by a sole owner.[62]

A. From Negotiation to Sale

In all empirical projects, one has to be careful in selecting which time period to examine. *Myth* seeks more than to understand the past; it also strives to improve the current operation of Chapter 11.[63] It examines data in the hope of discerning which set of policies will work better today and in the future.[64] Thus, one has to probe the extent to which the past that

60. *See* Baird & Rasmussen, *Twilight*, *supra* note 16; Baird & Rasmussen, *supra* note 13.

61. On how one would go about answering this question, see Rasmussen, *supra* note 16.

62. In *Myth*, LoPucki makes two puzzling observations. The first is that Baird and I believe that conflicting economic incentives can be safely ignored. LoPucki, *supra* note 1, at 1365. This statement is puzzling because, as far as I know, we have never thought that to be the case. Rather, we seek to ascertain which parties are exercising control and the extent to which their incentives deviate from the goal of maximizing social welfare. The second puzzling observation is that my failure to endorse the proposition that the law should vest control rights directly in residual claimants "suggests that at long last Freddy is really, finally, dead." *Id.* at 1367. The puzzle here is that I have never suggested that bankruptcy law be rewritten to somehow put residual claimants "in charge." That said, it remains fruitful to examine the economic incentives of the various contestants in bankruptcy. Some of these may be residual claimants, some may not. If LoPucki wants me to banish "residual" from my lexicon, I cannot accede. If, however, all he wants is that I refrain from endorsing proposals that would have the Bankruptcy Code somehow vest control rights in "residual claimants" in all cases, I am happy to do so.

63. LoPucki, *supra* note 1, at 1341–43.

64. *Id.*

LoPucki has studied bears a resemblance to the current state of affairs, at least on the subject that we are exploring.[65]

Recent years have seen dramatic changes in Chapter 11 practice. While these changes may not affect the number of priority levels of a given corporate group, they go the heart of corporate governance in financially troubled enterprises.

Myth is about corporate governance during Chapter 11. The types of governance decisions that need to be made in current bankruptcy practice differ markedly from those that were at the fore in the early and mid-1990s. To see this, it is helpful to look quickly at a set comprised of more recent cases. LoPucki uses a six-year period beginning at the start of 1991.[66] Taking the most recent six-year period for which LoPucki has data (1998-2003) and putting the comparable figures that LoPucki obtains using his time period in parentheses, we find that 332 (159) corporate groups completed their Chapter 11 proceedings.[67] Of these, 175 (124) emerged at the completion of the Chapter 11 case.[68] Of these 175 (124) companies, 41 (102) have filed a 10K.[69] Removing prearranged bankruptcies from this 41 (102) (for the reasons discussed in Part II),[70] we are left with 18 (54) companies. Thus, even though more than twice as many large, publicly held corporations completed Chapter 11 cases in the most recent six-year period as in the period that LoPucki analyzed, the number of publicly held corporations that emerge after Chapter 11 has decreased by two-thirds.

What is happening to the Chapter 11 caseload? The dominant fact is that the number of sales of firms while in bankruptcy has dramatically increased.[71] This is not the place to discuss the full import of these changes for bankruptcy generally[72]—the salient point for this response is that when discussing the corporate governance of financially embarrassed

65. One should not, however, fall victim to the vice of waiting forever as more and more data is gathered. It is a question of judgment as to when a policymaker has sufficient data, both in amount and in relevance, on which to act. The changes discussed below, however, are of a nature that would make it imprudent to prescribe policy based solely on the data in *Myth.*

66. LoPucki, *supra* note 1, at 1350.

67. *See* LoPucki, *supra* note 42.

68. *See id*.

69. *See id*. For one company the 10-K is not yet due.

70. *See infra* notes 40–52 and accompanying text.

71. For a detailed description of Chapter 11 cases completed in 2002, see Baird & Rasmussen, *Twilight*, *supra* note 16, at 675–85.

72. Douglas Baird and I have engaged with LoPucki on this topic elsewhere. *See* Baird & Rasmussen, *Twilight*, *supra* note 16; Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 16; Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird & Rasmussen's* The End of Bankruptcy, 56 STAN. L. REV. 673 (2003).

corporations, one needs to focus on the key decisions that have to be made. Today, perhaps the most important decision is whether to sell the business as a going concern or attempt to negotiate a new capital structure.

On this score, LoPucki's data provide no insight into the dynamics that lead to the sale of the business. LoPucki asserts that "the existing method [of corporate governance] is to impose on the incumbent managers fiduciary duties to all parties in interest and leave those managers in otherwise unfettered control."[73] This proposition does not arise from his database, and it cannot be squared with the landscape of today's Chapter 11. Directors of financially distressed corporations have few degrees of freedom.[74] Lenders are often the ones that insist on a sale.[75] The directors often cannot take action in Chapter 11 without the blessing of the lenders that are providing the financing for the case. Indeed, prior to the filing itself, the directors often depend on the lenders not calling a default on the outstanding loans.

The sale of the business as a going concern is an ever-present option in today's environment. We witness companies filing Chapter 11 in order to complete a sale to which the company has already agreed. In other cases the option of selling the business is selected during the proceeding. Sales terminate governance issues, at least as far as bankruptcy is concerned. The buyer puts in place its desired governance structure, and the bankruptcy proceeding continues with the task of divvying up the proceeds.

Of course, not all cases end in sales. Negotiated reorganizations may have declined dramatically, but they have yet to disappear entirely. Often, there is not a sale only because the lenders prefer to reconfigure their investment in the company rather than to put the company on the block.[76]

In attempting to assess the extent to which the incentives of those in control correspond with the goal of maximizing social welfare, the benchmark remains the actions of the sole owner. In a world where we see creditor control throughout the bankruptcy process and with a sale of the

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73. LoPucki, *supra* note 1, at 1341.

74. For an extended discussion of how lenders obtain and exercise control of financially distressed corporations, see Baird & Rasmussen, *supra* note 13.

75. Not always, though. For example, in Adelphia's Chapter 11 proceeding, it was the shareholders who pushed for a sale. The salient point, however, is that a sale of the business is usually a serious option in most reorganizations of the size that LoPucki tracks.

76. For an argument that an auction may not be the value-maximizing course of action in every Chapter 11 cases, see Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992).

business an ever-present option, what insight do LoPucki's findings on the existence of multiple priority levels provide?

B. To Sell or Not to Sell

The alternative to selling the business is to put a new capital structure in place and continue with the business, perhaps with a new business model. The decision whether or not to sell will depend in part on the dynamics of the expected negotiations that would otherwise take place. To the extent that one group decides that it would fare better under a sale rather than a reorganization, it will push for placing the enterprise on the block. To the extent that a group believes that it would capture more in a reorganization, it will raise objections to the sale. When one group is in control of the reorganization effort, its incentives are the ones that matter most. Thus, we need to ask the extent to which LoPucki's findings suggest a skewing toward the negotiations for a new capital structure or the sale decision.

1. Conflicts in Negotiations

Myth worries about the conflicts of interest that exist when the parties seek to reorganize the business.[77] Consider the primary conflict that LoPucki focuses on in *Myth:* the conflict in investment policy when the corporation is not being sold.[78] LoPucki's basic argument runs as follows: (1) Corporate groups create multiple priority levels within their unsecured debt; (2) at the time that the groups file for bankruptcy, it is often the case that more than one of these priority levels is a residual claimant in that they stand to receive some but less than full repayment; (3) governance of the enterprise cannot be entrusted to the residual claimant both because it is difficult to predict at the commencement of the case which groups will have residual status during and at the end of the case, and because the competing priority levels have interests that conflict.[79]

Take the last step first. It is central to LoPucki's argument[80] that there are conflicts among priority levels, and that these conflicts imply that the residual claimants—even if we can identify them—are ill-suited to exercise control over the operations of the enterprise. However, it is

77. LoPucki, *supra* note 1, at 1344–45.
78. *See id*. at 1350.
79. *See id*. at 1343–49.
80. *Id*. at 1344–45.

important to specify the conflicts that exist among these investors. LoPucki extends the standard conflict that exists between debt and equity to the case where unsecured debt is parceled out among different priority levels.[81] All things being equal, those lower on the priority hierarchy prefer projects with high variance because they capture all the upside and much of the downside falls on the more senior investors, and those who rank high in terms of priority have the opposite preference.[82] The conflict arises because differing investors hold different claims on the cash flow of the enterprise. Thus, in the case of more than one residual claimant, those claimants that are paid in full or nearly so will seek low variance projects, while those receiving less will seek out high variance projects. This conflict over project choice renders the residual claimants incapable of speaking with a unified voice.

The problem for LoPucki's argument is that conflict disappears (or at least is greatly reduced) by the end of the bankruptcy proceeding. LoPucki's findings place a dollar value on all recoveries. He does not explore the actual instruments the old claimants receive in the reorganized entity. In fact, residual claimants tend to be paid in stock.[83] Consider, for example, the plan of reorganization in *In re Envirodyne*,[84] one of the Chapter 11 cases that ended during the time period that LoPucki analyzed. The debtor had three issues of debt with differing priority levels.[85] The first level, the senior discount notes, was in the money.[86] The plan of reorganization replaced the old notes with new notes of equal value.[87] The middle tranche, a senior subordinated debenture that paid 14% interest, had a face value of $200 million.[88] These claimants saw their notes cancelled, and instead received common stock that the plan valued at $121 million.[89] The most junior of the bond holders, the subordinated notes, were owed $100 million.[90] The plan provided that they would receive $20

81. *Id*. at 1356.

82. Jensen & Meckling, *supra* note 29.

83. While I do not have comprehensive data on the capital structure of emerging corporations, I am comfortable with the above assertion for two reasons. First, I have followed the reorganization plans and spoken with a number of attorneys over the past few years. The plans that I have seen and the attorneys that I have spoken with had me to the definite conclusion that junior debtholders tend to receive the bulk of their distribution in equity. Second, given that we are talking about the residual claimants, it is highly plausible that they are paid in junior securities.

84. In the Matter of Envirodyne Industries, Inc., 29 F.3d 301 (7th Cir. 1994).

85. *Id*. at 303.

86. *Id*.

87. *Id*.

88. *Id*.

89. *Id*.

90. *Id*.

million in stock of the new company.[91] These last two groups are both residual claimants in the sense that neither is being paid in full. But do they have differing interests on issues of corporate governance?

After the case is over, both groups of erstwhile debtholders will be shareholders. At that time, they want to maximize the value of equity. If the parties anticipate that they will have the same type of interest in the reorganized corporation immediately after the Chapter 11 proceeding is complete, one would expect that they would work together during the proceeding to ensure that that interest is worth as much as possible. The conflict that LoPucki posits evaporates.

This should not be surprising. The various investors in Chapter 11 have an opportunity to put in place a capital structure that makes sense for the reorganized business. Indeed, Chapter 11 is designed to remove impediments that exist outside of bankruptcy that make it difficult for corporations with excessive debt levels to reduce that debt. One would expect that, during the bankruptcy proceeding, the parties would seek to implement a capital structure that maximized the value of the business. There is no doubt that each party wants to maximize its own investment. But, at least as an initial matter, the more a corporation is worth, the more the various investors stand to receive.

To be sure, the issue of a debtor's capital structure as it exits bankruptcy is underdeveloped. Corporations that leave bankruptcy have debt as well as equity.[92] While important scholarship was done looking at the capital structure of businesses that emerged from bankruptcy 20 years ago,[93] I am unaware of more recent studies on this score.[94] Similarly, little or no work exists on the exit financing that a corporation often procures in order to consummate its plan of reorganization. As we see in the United Airlines bankruptcy, the need to procure exit financing casts a long shadow on the reorganization. Still, it is generally the case that

91. *Id*.

92. Some all-equity corporations do emerge. These corporations tend to have no assets other than the prior entity's tax-loss-carryforwards. *See* Gilson, *infra* note 93, at 178–79.

93. The best papers here are Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161 (1997), and LoPucki & Whitford, *supra* note 31. Both papers use cases from a time period earlier than the one used in *Myth*.

94. The businesses that emerged during the 1980s tended to be more highly-leveraged than competitors in their industry. Depending on the metric used, firms leaving bankruptcy at that time had leverage greater than the industry average approximately two-thirds and three-fourths of the time. *See* Gilson, *supra* note 93, at 166 (reporting that 65.5% of the corporations in his study had a leverage ratio greater than the industry median); Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 607 (1993) (reporting a 76% figure). This higher leverage, however, may reflect the optimal capital structure for these businesses. Gilson, *supra* note 93, at 182–83.

corporations that leave bankruptcy via reorganization have both debt and equity.

In reorganizations where the senior lenders are in control, the fact that the reorganized corporation has both debt and equity provides some insight into whether the use of this control tends to maximize the value of the business. The senior creditors receive debt in the reorganized corporation, albeit in a lower amount than what they were originally owed, along with equity. There are some projects that they would forgo as holders of both debt and equity that equity holders would find attractive. While potential conflicts over investment policy are not eliminated completely—one can always find an agency cost if one looks hard enough—they are greatly reduced by the expectation that the dominant player expects to have both a debt and an equity interest in the reorganized company. Indeed, a holder of debt and equity may have incentives that are closer to those of a sole owner than are the incentives of one who holds only debt or only equity.

This congruity of interests concerning the future operations of the enterprise does not mean that differing priority classes do not engage in quarrels. Given that these claims are not going to be paid in full, and the fact that equity is going to be distributed, valuation disputes are often heated. The fact that senior lenders may be exercising control over the deployment of the debtor's assets does not to ameliorate this conflict. A low valuation of the business will leave more stock in the hands of the more senior claimants, while a higher valuation will increase the amount that goes to the junior class. To illustrate, consider LoPucki's example with three creditors each owed $100 and the investment contracts provide that one creditor (C) will subordinate its debt to the debt of another creditor (A).[95] LoPucki posits that the business is worth $132, with Creditor A getting $88 by virtue of the subordination agreement with Creditor C, Creditor B getting its pro rata share of $44, and Creditor C receiving nothing.[96] These creditors are likely to take their return in shares, rather than in cash or debt instruments.

Assume that the reorganized corporation is going to distribute 100 shares of stock: if all agree that the value of the corporation is $132, Creditor A will receive 67 shares and Creditor B 33 shares and Creditor C would receive no distribution. But what if a value of $177 were assigned to the reorganized entity? As to the division of this value, Creditor A

95. LoPucki, *supra* note 1, at 1358.
96. *Id*.

would be paid in stock worth $100, Creditor B in stock worth $59, and Creditor C in stock worth $18. Assuming the same 100 shares to distribute, Creditor A would now get 56 shares, Creditor B would still receive 33 shares, and Creditor C would recover 11 shares. Creditor A would thus have an incentive to argue for the $132 valuation, which would provide it with two-thirds of the equity in the reorganized corporation, while Creditor C would press for the $177 figure, which would allow it to receive 11% of the new stock.[97]

But Creditors A, B, and C have no dispute over how to operate the business. Regardless of which valuation is selected, they will each hold stock in the new company. Once Chapter 11 is complete and the new securities are issued, their interests are perfectly aligned. In terms of governing the corporation, these differing investors have the same interest.

The discussions spurred by the possibility of substantive consolidation exhibit a similar pattern. As LoPucki demonstrates,[98] at times, multiple residual claimants result from structural priority. Not only does structural priority create valuation conflicts similar to that just discussed—each party has an incentive to press for an aggressive valuation of its entity and a stingy valuation of the other constituents of the corporate group—but also the class that holds claims against a relatively low-asset entity can press for substantive consolidation.[99] Consider in this vein the recent WorldCom bankruptcy. MCI, prior to its being taken over by WorldCom in a stock merger, issued debt on an unsecured basis.[100] WorldCom then acquired the stock of MCI. This acquisition had no affect on the rights that the MCI debt holders had against the MCI assets. MCI's initial plan of reorganization sought to substantively consolidate the MCI debt and the

97. A sale would terminate the valuation dispute, but I am assuming for the moment that the investors would find it in their interest to not put the enterprise on the market.

98. LoPucki, *supra* note 1, at 1361–64.

99. The extent of substantive consolidation in bankruptcy is yet another area we do not understand as well as we should. The case law on substantive consolidation sets forth a high threshold, but it is unclear the extent to which substantive consolidation happens in practice. *See, e.g.*, *In re* Augie/Restivo Baking Co., Ltd., 860 F.2d 515 (2d Cir. 1988); *In re* Auto-Train Corp., 810 F.2d 270 (D.C. Cir. 1987). Indeed, LoPucki finds structural priority by looking at distributions in confirmed plans. LoPucki, *supra* note 1, at 1361. To the extent that substantive consolidation occurs, this could result in LoPucki underreporting the number of firms that had structural priority when they entered Chapter 11.

100. This debt can come in different flavors, including QUIPS, which are a form of subordinated debt just on the debt side of preferred stock. On the ability to craft instruments that have many of the economic features of equity but the tax status of debt, see Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEX. L. REV. 859 (2002).

WorldCom debt.[101] WorldCom argued that there had been over $380 billion in transfers among related entities, and the cost of unscrambling the omelet was too high.[102] MCI debtholders bitterly objected and sought to derail the plan of reorganization.[103] Ultimately an agreement was reached, with the MCI holders receiving 80 cents on the dollar and the WorldCom bondholders receiving a 36% payout.[104]

Structural priority here led to intense conflict on the issue of substantive consolidation. What it did not do, however, was lead to dispute over which investment policy the reorganized MCI should follow.

2. Conflicts in Sales

To the extent that agency costs inherent in multiple levels of debt are dampened in those cases where the debtor leaves Chapter 11 with a new capital structure hammered out during the proceedings, this still leaves for consideration the largest issue in bankruptcy governance today. Should the business be sold? Do the multiple levels of residual claimants that LoPucki documents suggest that this decision is riddled with agency conflicts?

The standard account of Chapter 11 recognizes that shareholders prefer a reorganization that preserves the option value of their shares for sale.[105] A sale would yield insufficient funds to give the shareholders a dime, but a reorganization allows them to maneuver in ways that would allow them to retain some interest in the reorganized corporation. Today's Chapter 11, however, frequently cancels the shareholder interests in full. The underlying concern, however, remains. Rent extraction by shareholders may have been replaced by rent extraction by unsecured creditors. In theory, the residual claimants that LoPucki unearths could press for a negotiated settlement when a sale would be quicker and cheaper. To the extent that these claimants could use the process to systematically receive equity that overcompensates them based on their pre-petition claims, they

101. *See* Randall L. Klein & Dmitri G. Karcazes, *Kmart, WorldCom & Adelphia, Mega-Issues from Mega-Cases*, ABF J., Oct. 2003, at 18.

102. *See* Debtors' Memorandum of Law in Support of Substantive Consolidation and in Opposition to Objections Thereto, *In re* World Com, OZ-13533 (AJG) (Bankr. S.D.N.Y. Sept. 4, 2003), *available at* www.elawforworldcom.com.

103. *See* Klein & Karcazes, *supra* note 101, at 3.

104. The MCI claimants were given new notes, and the WorldCom bondholders were allowed to choose between new notes or shares of common stock in the reorganized corporation. *See* Debtors' Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, *In re* WorldCom, 02-135233 (AJG) (Bankr. S.D.N.Y. Apr. 14, 2003), *available at* www.elawforworldcom.com.

105. *See* Douglas G. Baird & Thomas H. 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, 107 (1984).

would seek to do so. But we have no evidence that such pressures are at work today.[106] Indeed, we see cases where the junior creditors pass for a sale, fearful that a reorganization will place too low a value on the enterprise. To the extent that residual claimants expect to receive the fair value of their investments in either a sale or a negotiation over a new capital structure, they will not have a systematic preference to pursue one path over another based on their status as residual claimants. This is true regardless of whether there is one group that can lay claim to residual claimant status, or three or four.

LoPucki's primary argument in *Myth* supporting his prescription for corporate governance thus fails. The conflicts central to his account do not loom large. Yet this does not mean that other arguments for his vision of corporate governance while in bankruptcy do not exist. Indeed, LoPucki has elsewhere set forth a sustained case for his conception of how businesses should be run while in bankruptcy.[107] This is not the place for a detailed analysis of this proposition (for one thing, offering such an argument would lead to the cardinal sin of a comment being longer than the piece to which it is responding!). Nevertheless, I want to offer two brief thoughts.

The first is that the empirical evidence we have from corporate governance generally suggests that boards that are secure in their tenure underperform their peers. The evidence comes from research on the impact of staggered boards on corporate performance. Staggered boards effectively immunize a board from a hostile takeover.[108] The defenders of this structure, in tones that resonate with those of LoPucki, argue that the directors can run the company better if they are freed from short-term pressures.[109] Recent empirical work, however, demonstrates that these

106. The fact that the residual claimants would be shareholders in a corporation with debt if there is no sale does not imply that they would favor that outcome. To be sure, once they hold the stock, they may seek investment projects that place risk on the debtholders. But the debtholders themselves often end up with a controlling interest in the reorganized business. There is little chance in the near term for shenanigans aimed at expropriating debtholder wealth. Moreover, the amount of the debt and its interest rate are set at the same time as the shares are issued. Any residual ability the new shareholders have to grab value will be priced in the debt.

107. *See* Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741 (2004).

108. *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

109. *See, e.g.*, Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 830 (2002) ("Takeover defenses serve legitimate and useful purposes, including providing a company time and leverage to negotiate a better deal or find a better alternative, rebuff an inadequate or opportunistically timed bid, or remain independent and pursue its long-term business strategy—*if* the board determines that doing any of those things is in the best interests of the shareholders.")

boards reduce firm value by 3-4% on average.[110] While it would be a mistake to translate these findings to the environs of the bankruptcy court without scrutiny, they do suggest that boards may respond better when they are not insulated from various forces. Indeed, the extent to which creditors go to great lengths to ensure that they have control of the bankruptcy process suggests that they recognize the costs that can be incurred when directors are not attuned to those with money on the line.

The second point is one framing the debate going forward. To understand the dynamics of modern corporate reorganizations, we have to do more than identify which actor exercises formal legal authority. We need to understand who these actors are and what factors shape their decisions. As to the identity of those who sit on a debtor's board of directors, we see that boards in bankruptcy undergo dramatic turnover. When Baird and I looked at firms that emerged via a reorganization rather than a sale in 2002, we found that in a majority of cases a new board of directors is appointed during the bankruptcy process.[111] Indeed, plans of reorganization sometimes give appointment power to specific groups of investors.[112] Considering who appoints the board members provides insights into how the board will exercise its powers. Before assessing whether current practice is normatively desirable, we need a better understanding of the dynamics that guide the corporate decisions of enterprises that are in financial distress, and what alternatives are available.

To this end, there are a host of questions that could shed light on current practice: Which creditors have control? What alternative choices do they face? To what extent do they have incentives to exercise their control in a way that fails to maximize the value of the enterprise? Is there a viable alternative that we could expect to do better?[113] In other words, does corporate governance in Chapter 11 today benefit the residual owner?

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110. *See* Lucian Arye Bebchuk & Alma Cohen, The Costs of Entrenched Boards (June 2004) (Harvard Discussion Paper No. 478).

111. *See* Baird & Rasmussen, *Twilight*, *supra* note 16, at 697–98.

112. *See id*. at 698.

113. Barry Adler and David Skeel have both raised thoughtful concerns on the ways in which creditor control could fail to maximize the value of the business. *See* Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 226–32 (2004); *see generally* Skeel, *supra* note 16, at 917.

CONCLUSION

Academics fancy elegant solutions. Finding the one group that offers the best chance to address the problems of the financially embarrassed firm is an inviting target. Locate Hercules, be it in the residual claimant, the board of directors, the creditors or the bankruptcy judge, and let him do the rest. The world as we find it is always going to be more complex. This complexity, however, does not doom the enterprise. Those businesses that emerge from Chapter 11 have new capital structures and governance structures that are either the product of negotiations among sophisticated parties or imposed on the corporation by an entity that has bought the business. LoPucki has added to our understanding of the capital structures of corporate groups that enter Chapter 11. What he has failed to do, however, is to demonstrate that the law can improve on the way decisions are made today. Many questions, however, remain open, and we need to continue efforts to explore the exercise of control rights before, during, and after Chapter 11. I have no doubt that LoPucki will be one who continues to be a leader in our efforts to better understand the workings of corporate reorganization practice.