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# Hosing Down Senior Claims with a Quicker and Dirtier Chapter 11

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# HOSING DOWN SENIOR CLAIMS WITH A QUICKER AND DIRTIER CHAPTER 11

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Professors LoPucki and Whitford (L & W) have written an interesting paper.[1] It builds on their earlier article on corporate governance.[2] A thorough critique would require a confrontation with the basic underpinnings of Chapter 11 (as it exists or as it might be revised), a project beyond the scope of this comment. So I shall defer, for the most part, more overarching observations on Chapter 11 in order to address some specific points raised in their paper. There is both much to admire and much to question in the paper. I shall turn first to the premises and proposals with which I agree.

L & W would have the Bankruptcy Code impose an express duty on a Chapter 11 debtor in possession to pursue what they call "optimal investment policies," or "OIPS" (a bit like "OOPS"), instead of the "prudent investment policies," or "PIPS,"that they claim are the norm in Chapter 11. Assuming that the pursuit of OIPS maximizes wealth (an assumption that is not necessarily accurate), I applaud their goal.

Presumably this wealth-maximizing OIPS standard would override other considerations, such as the (noncreditor) interests of employees in a plant that would be closed and other so-called "community" interests that might conflict with the unswerving pursuit of OIPS. I believe that L & W have this part right as well.[3] One would hope that they would not have OIPS rescue the shareholders, even if it puts the unsecured creditors at greater risk, only to forgo OIPS if the result would harm those who do not even have claims or interests.[4]

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1. Lynn M. LoPucki & William C. Whitford, *Compensating Unsecured Creditors for Extraordinary Bankruptcy Reorganization Risks*, 72 WASH U. L.Q. 1133 (1994) [hereinafter LoPucki & Whitford, *Compensating Unsecured Creditors*].

2. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*].

3. Perhaps I am hoping against hope that I am reading L & W correctly. In their earlier article they criticized wealth-maximization as an abstract strategy, apparently because that approach fails to take account of costs imposed on persons other than creditors and interest holders. *See* LoPucki & Whitford, *Corporate Governance*, *supra* note 2, at 752.

4. Alternatively, perhaps L & W would permit the interested segments of the "community" to make risk compensation payments to those adversely affected by a deviation from OIPS.

I also applaud the principle that underlies L & W's proposal for "risk compensation payments" to those who are placed at greater risk by the pursuit of OIPS: "[W]hen one party's rights are commandeered for the benefit of the group, the group should compensate that party."[5] In their example,[6] when the debtor in possession pursues OIPS for the benefit of the shareholders who stand to gain, L & W maintain that the shareholders must compensate the unsecured creditors for their losses (or additional risk) and although not applicable in the example, extinguish any junior claims. If the shareholders wish management to gamble with the prospective distributions to the unsecured creditors (95% to 100%, in the example), they should put their money on the line.

I could embrace happily principled law reforms that would enhance wealth and cause winners to compensate losers. Unfortunately, I worry that the scheme that L & W have proposed would achieve neither goal. It is not clear that the scheme would enhance wealth. In some cases it may give junior interests something for nothing and give senior interests nothing for something. And it could do so without the prophylactic structure of the plan confirmation process. I now turn to this dark side of the L & W proposal.

Consider again the restaurant firm example.[7] A quick liquidation would pay the unsecured creditors in full—$100 million—leaving nothing for the shareholders. Pursuit of PIPS also would result in a payout of $100 million when the plan is confirmed after two years, resulting in an assumed present value of unsecured claims equal to $95 million. Again, the shareholders would receive nothing. The OIPS approach, however, would have the firm hock all of its assets, borrow $100 million, and adopt a new format for the restaurants. Under the L & W risk compensation scheme, the shareholders would transfer 84% of the stock to the creditors and would retain 16%. OIPS has a 50% probability of success.[8] If it succeeds, the creditors will be paid in full and will have, in addition, stock worth $117.6 million, while the current shareholders' stock would be worth $22.4 million. If the OIPS plan fails, the postpetition secured lender will be paid in full and the prepetition creditors and shareholders will receive nothing.

As proposed, the L & W risk compensation scheme harbors at least two major flaws. First, the determination of OIPS and the application of the risk compensation scheme are so indeterminate and controversial that the

5. LoPucki & Whitford, *Compensating Unsecured Creditors*, *supra* note 1, at 1147.

6. *Id. passim.*

7. *Id.* at 1137-39.

8. I shall overlook the fact that no sane secured lender would extend credit if it knew there was a 50% chance of default and foreclosure.

current system could not cope satisfactorily. Second, the risk compensation payments are inadequate.

L & W seem to believe that OIPS and PIPS, and the expected results of each, are sufficiently determinable to enable management to devise assumptions like those in their example. Without such assumptions, one cannot apply the "risk compensation" formula. But how can anyone really know "facts" such as this package of assumptions? How can anyone know that there is a 50% (as opposed to a 70% or a 30%) risk of success or failure? How can anyone know that if the project is successful the value of the assets will be $240 million greater than the secured debt? In real life one can only attempt such predictions. Although we might believe that there is an equal chance of success or failure, we also know that there is great uncertainty as to that probability. L & W fail to address the softness of these factual assumptions.[9]

Consider also the ultimate arbiter of these facts upon which the course of the firm will turn. In all likelihood, the shareholders and management are arguing that the OIPS tack is a "can't miss." The unsecured creditors no doubt are urging that this is the worst idea since "New Coke." And each group surely has well-paid experts to vouch for their conclusions. Probably nobody is claiming that there is only a 50% chance of success. Who decides? The decision will be made by (or negotiated in the shadow of) the bankruptcy judge.[10]

In stay-lifting litigation the court typically must determine the value of discrete collateral.[11] But the closest analogue to OIPS litigation under current law is stay-lifting litigation concerning the prospects of an effective reorganization.[12] That decision is merely an up or down proposition. L & W, however, have proposed a model that, in their example, has the bankruptcy judge approving management's claim that OIPS will increase the market value of the firm from $100 million to $105 million.[13] I doubt

9. Data rounded to the nearest 1000 cannot produce a meaningful result calculated to the third decimal place; garbage in, garbage out. By the same token, when the assessments of future business operations and the probabilities of various results are sufficiently speculative, slight variations in prospective valuations and probabilities are not significant.

10. Some will not be surprised by the confidence that L & W place in the ability of the bankruptcy courts to get it right. *See* James W. Bowers, *The Fantastic Wisconsylvania Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773 (1993).

11. *See* 11 U.S.C. § 362(d)(1) (1988) (providing that the automatic stay will be lifted "for cause, including the lack of adequate protection of an interest in property").

12. *See* 11 U.S.C. § 362(d)(2) (1988) (providing that the automatic stay will be lifted if "the debtor does not have an equity in such property" and "such property is not necessary to an effective reorganization"). Those who hail the judicial reluctance, at least early in Chapter 11 cases, to find that an effective reorganization is unlikely will warmly embrace the OIPS model.

13. LoPucki & Whitford, *Compensating Unsecured Creditors*, *supra* note 1, at 1138 tbl. 2.

that the salami can be sliced that thin. L & W's proposal would let management and the bankruptcy judge do just about whatever they want with very little risk that the determination could be found clearly erroneous. The determination would not be clearly anything—correct or erroneous!

The proposal would ensure substantial litigation over OIPS and PIPS. L & W acknowledge that the factual determinations would be "quick and dirty," but argue that seat-of-the-pants, rough-justice calculations involving "guesswork" should be enough to induce OIPS.[14] Maybe so, but the risk compensation payments are the whole ball game for the unsecured creditors here. In the example, the creditors would give up a recovery of $95 to $100 million and would be exposed to a 50% chance of no recovery whatsoever.

The OIPS proposal imposes on management a litigation model of corporate governance. Maybe management, operating in the shadow of competing claims for risk compensation and oversight by the bankruptcy judge, will get it right. But I wonder why the management that landed the firm in Chapter 11 can now be so sure of its strategy. And if the OIPS/risk compensation proposal is anywhere close to an optimal system, I wonder why corporate boards and officers operate as they do instead of holding hearings before a neutral arbitrator to resolve important management decisions. Also conspicuously absent in the L & W proposal is evidence of the management approach taken by firms *before* filing for Chapter 11 and by firms who have not filed for Chapter 11. Did the management strategy of those firms more closely resemble PIPS or OIPS? To pose a metaphor based on health, not wealth, if one could learn much about corporate governance from looking only at firms in Chapter 11, the field of preventive medicine would be dominated by forensic pathologists.

Even if the indeterminacy of the judicial model of OIPS were solved, my most serious concern about the L & W proposal would remain—the conception of "risk compensation payments." Not only would the proposed transfers to the unsecured creditors in the example fail to compensate the creditors for their additional risk, but the contemplated transfers are not payments at all.

Under PIPS, the unsecured creditors have a 100% chance of being fully paid $100 million, with a present value of $95 million. Under OIPS, they will have a 50% chance of receiving $0 on their claims. How would L &

14. Moreover, L & W also acknowledge that: "The creditor-shareholder dichotomy that we have employed throughout this paper is, in at least one important respect, an oversimplification of the problem . . . . In a large, publicly held company, there are likely to be claims, and perhaps even shares, having several levels of priority." LoPucki & Whitford, *Compensating Unsecured Creditors*, *supra* note 1, at 1147.

W compensate the unsecured creditors for the risk that they will lose everything? The creditors would receive *stock*. If, as the unsecured creditors fear, OIPS fails, the creditors receive nothing even after taking account of the risk compensation payments. That is because they received, as a protection against the risk of failure, something that by definition will be worthless upon failure. Go figure.

One response to my analysis is that the creditors received something that the bankruptcy judge says is worth $51 million, leaving the original shareholders with stock that the bankruptcy judge says is worth about $10 million. But does anyone really believe this valuation? Would the unsecured creditors really believe it? If these values were real, would not there be *someone* in the world who would pay the unsecured creditors $51 million in exchange for the stock? Would not the original shareholders pay $51 million for $61 million of stock if they were real believers? If there is a market for the stock, of course, the unsecured creditors could simply sell their shares. But if there were such a market, the firm could issue new shares and pay the creditors. If there is not a market, should not the shareholders be required to *pay* the unsecured creditors with real money instead of OIPS play money? If nobody in the world is willing to pay $51 million for the stock to be given to the unsecured creditors, is it too radical to venture that it may not be worth $51 million? To be adequate, the risk allocation payments must be real payments, not merely allocations of junior interests.[15]

Consider the result if, on the day after the judge ordered that the L & W version of risk allocation payments be made to the unsecured creditors, those same creditors (who now own five-sixths of the stock) came to court and said: "The proposed OIPS business plan stinks. We are the ones who have the most to lose and the most to gain and we want out; please liquidate." Would the judge be bound to ignore their pleas? Should the creditors' residual status disenfranchise them as shareholders? Once risk compensation payments have been allowed, is that the end of the matter? Would the case stay in a constant state of flux, with various parties reacting to the ebb and flow of the debtor's fortunes and foibles with their own repetitive calls for risk compensation payments?

I do not want to leave the impression that I see no room and no need for a system of risk compensation payments. For example, it might be wise to clarify the Bankruptcy Code to make it clear that *consensual and*

15. For example, an administrative expense priority cannot qualify as adequate protection of a property interest. 11 U.S.C. § 361(3) (1988). It would be anomalous to treat an equity interest in a debtor as the "indubitable equivalent" of a creditor's claim against a solvent (or near-solvent) debtor.

*voluntary* risk compensation payments are permitted and, perhaps, encouraged. But judicially forcing parties to accept junior interests calculated on enormously complex and difficult assessments of competing business plans goes too far.

Finally, I confess, as I must, that my distrust of the L & W OIPS/risk compensation scheme derives in part from my view of bankruptcy and its relationship to private rights and interests. Whether a claim is based in contract or tort, it is commonly accepted that what distinguishes an enforceable claim from something else is the ability to call upon the state's judicial system in order to recover on the claim. The world would not have to work that way, of course. The state could decline to intervene in and settle purely private matters, but our legal culture is otherwise.

When a claimant does employ the judicial system to recover on a claim, the end game converts the obligor's property into property of the claimant, such as by levy of execution, sheriff's sale, and so forth. Bankruptcy is a part of that system. Its domain is an orderly procedure that should allow claimants to obtain at least as much as they would have obtained in the nonbankruptcy enforcement process, and perhaps more. But bankruptcy law and efforts to "reform" it largely remain captured. They are captured by those who have nurtured bankruptcy as an insular cottage industry, an alternative form of business structure, a government, a religion, and as something very, very special. The L & W proposal is of the cottage industry genre, seemingly profound but in reality only tinkering with the fine points.

Bankruptcy is civil procedure—no less but absolutely no more.