Michigan Law Review

Volume 91 | Issue 1

1992

Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig

Lynn M. LoPucki
University of Wisconsin

Follow this and additional works at: <https://repository.law.umich.edu/mlr>

Part of the [Bankruptcy Law Commons](#), and the [Legislation Commons](#)

Recommended Citation

Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992).

Available at: <https://repository.law.umich.edu/mlr/vol91/iss1/4>

This Correspondence is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

CORRESPONDENCE

Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig

Lynn M. LoPucki*

The same amount of smoke would be released from the factory's chimney whether the factory owner or the householder was legally responsible for the smoke damage. If this proposition strikes you as incredible on first hearing, join the club. The world of zero transaction costs turns out to be as strange as the physical world would be with zero friction.

— George J. Stigler¹

INTRODUCTION

The beating of the drums grows louder. In academia, they beat for a market-based solution to the problem of bankruptcy reorganization. The product is a steady procession of articles, each calling for the market to play a larger role. Most deposit a specific proposal for reform as their offering at the academic altar.² Outside academia, the drums

* Professor of Law, University of Wisconsin, A.B. 1965, J.D. 1967, Michigan; LL.M. 1970, Harvard. — Ed. I wish to thank Samuel Bufford, Bill Campbell, Blair Kauffman, Neil Komesar, Donald Korobkin, Marjorie Murphy, Bryan Schneider, Grace Shohet, David Skeel, John Thomure, Jay Westbrook, and William Whitford for their helpful comments on earlier drafts of this article. My coresearcher, William Whitford, generously consented to the use of data from our study, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, that has not been included in joint publications. I am grateful for valuable research assistance provided by John Thomure.

1. George J. Stigler, *The Law and Economics of Public Policy: A Plea to the Scholars*, 1 J. LEGAL STUD. 1, 11-12 (1972).

2. Each of the publications listed in the next paragraph questions the usefulness of chapter 11 of the Bankruptcy Code; each employs a model that in at least certain respects assumes that capital markets are perfect or near perfect and that transaction costs are nonexistent or insignificant. Proposals for reform are noted.

The suggestion to eliminate chapter 11 was first made by either Baird or Jackson in 1986. THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 223 (1986) ("There is no reason why chapter 7 could not be used as the vehicle to sell the firm as a going concern in the same way that companies go public."); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 128 (1986) ("[T]he entire law of corporate reorganizations is hard to justify under any set of facts and virtually impossible when the debtor is a publicly held corporation."). It has been repeated numerous times. See, e.g., Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 489 (1992) ("Congress should repeal bankruptcy's reorganization provisions."); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785 (1988) (proposing to substitute a scheme of reorganization in which shareholdings are canceled without compensation unless shareholders pay their prorated share of

sound a different message: chapter 11 poorly serves the public by holding creditors at bay and thereby protecting incompetent managers against the natural consequences of their own mismanagement.³ In their provocative call for the repeal of chapter 11,⁴ Michael Bradley and Michael Rosenzweig have fused these highly resonant themes with data that purport to show the virtually complete failure of chapter 11 to serve the interests of either creditors or shareholders. With publication of this powerful product in the *Yale Law Journal*, the questioning and complaining about chapter 11 have given way to demands for action. Those demands have captured the attention of the financial press⁵ and threaten soon to reach the body politic.⁶

all debts of the company within four days after notice); James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2141 (1990) (employing assumptions of perfect markets and other hypothetical conditions to demonstrate that bankruptcy is unnecessary because debtors will liquidate and distribute their own assets: "The purpose of this study has been to demonstrate that we lack any persuasive theory for why we have or ought to have bankruptcy legislation."); Philippe Aghion et al., *The Economics of Bankruptcy Reform* (May 1992) (unpublished manuscript, on file with author) (employing Bebchuk's new approach as part of a "market-based" proposal that would substitute for chapter 11). But see Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411 (1990) (implicitly employing perfect market zero transaction cost assumptions to argue that, because chapter 11 endures, it must be efficient).

3. E.g., Michael Bradley & Michael Rosenzweig, *Time to Scuttle Chapter 11*, N.Y. TIMES, Mar. 8, 1992, § 3, at 13 ("[W]e believe that the principal beneficiaries of Chapter 11 are corporate managers. . . . Chapter 11 . . . in fact serves mainly to protect managers' jobs."). Kallen argues as follows:

During the Eighties, Chapter 11 became . . . a powerful tool of megacorporations Chapter 11 permitted megacorporations . . . [and] the men who ran them to escape the consequences of their greed and incompetence. If viewed as a government program to provide large amounts of aid to giant corporations, the Bankruptcy Code has been one of the most successful federal programs.

LAURENCE H. KALLEN, *CORPORATE WELFARE: THE MEGABANKRUPTCIES OF THE 80S AND 90S*, at ix (1991); see also *A New Ending for Chapter 11*, THE ECONOMIST, Feb. 24, 1990, at 13 ("The managers of bankrupt companies are still consigned to the flames in some countries But when a big business files for reorganisation under chapter 11 of America's bankruptcy laws, it is all too often not the firm's managers who fry.").

4. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

5. Articles about Bradley and Rosenzweig's article abound. See, e.g., Emily Barker, *Pair Puts Spotlight on Chapter 11's Flaws*, AM. LAW., May 1992, at 119; Bradley & Rosenzweig, *supra* note 3, § 3, at 13 ("[W]e believe that the principal beneficiaries of Chapter 11 are corporate managers. . . . Chapter 11 . . . in fact serves mainly to protect managers' jobs."); Wade Lambert & Milo Geyelin, *Bankruptcy Lawyers Dispute Call for Scrapping Chapter 11 Process*, WALL ST. J., Mar. 19, 1992, at B5 (describing efforts of a group of bankruptcy lawyers to organize in opposition to the Bradley-Rosenzweig proposal); Andrew Leigh, *Are Federal Bankruptcy Laws Failing in Their Mission?*, INVESTOR'S BUS. DAILY, Apr. 9, 1992, at 4 (describing the Bradley and Rosenzweig study, quoting Rosenzweig and several critics); Allen R. Myerson, *Rethinking the Law That Gives Golden Eggs After the Goose Is Dead*, N.Y. TIMES, Apr. 5, 1992, § 4, at 2 (referring to the Bradley and Rosenzweig proposal as "[t]he most radical, attention-getting" and referring to the possibility of repeal as "unlikely"); Peter Passell, *Economic Scene: Fun, Games, Bankruptcy*, N.Y. TIMES, Apr. 29, 1992, at D2; Michelle Singletary, *Panel Votes to Form Bankruptcy Study Body*, WASH. POST, Mar. 20, 1992, at F1.

6. See, e.g., John Greenwald, *The Bankruptcy Game*, TIME, May 18, 1992, at 60 ("A recent *Yale Law Journal* article called for junking Chapter 11 altogether and letting sick companies

Much about chapter 11 is in need of improvement. But, as is so often the case, the resonant themes are not the right ones. All three legs of Bradley and Rosenzweig's argument for repeal are seriously flawed. The heart of their empirical argument is their claim to have shown that financially stronger companies reorganizing under chapter 11 have been paying less to both their creditors and their shareholders than did weaker companies reorganizing under prior law. In Part I below, I present several more plausible explanations for the stock and bond price phenomena they observed. In all likelihood, their data reflect not a difference in the efficiency of the Act and Code regimes,⁷ as they claim, but merely the arrival of the junk bond era. Chapter 11 is processing more highly leveraged companies.

Bradley and Rosenzweig's provocative assertion that chapter 11 shields managers from creditors while they expropriate for themselves the wealth of both bondholders and stockholders in no way follows from their empirical findings, nor is it true. In Part II, I present empirical evidence from several studies to show that during the reorganization of large, publicly held companies, managers are rarely the powerful actors that Bradley and Rosenzweig make them out to be. Reorganization managers are more likely to serve creditor interests directly or pursue some more complex course calculated to keep everybody happy and thereby preserve their jobs and reputations.

The third leg of Bradley and Rosenzweig's argument for repeal of chapter 11 is their assertion that, in its absence, the conflicts between failing companies and their creditors could be regulated through contracts and markets. In Part III, I argue that their analysis depends so heavily on the twin assumptions of perfect capital markets and zero transaction costs that it is not helpful in evaluating the usefulness of

die."); Aaron Pressman, *Can Chapter 11 Be Put Back Together?*, INV. DEALER'S DIG., Apr. 27, 1992, at 16 (linking the Bradley and Rosenzweig article with bankruptcy reform legislation currently pending in Congress). In what was seemingly a response to the Bradley and Rosenzweig article, Chief Justice William H. Rehnquist commented:

Chapter 11 has many detractors and some go so far as to reject the notion that financially troubled firms should be able to reorganize instead of liquidat[e]. They argue that Chapter 11 has a pro-debtor, pro-incumbent management bias that does not foster efficient allocations of assets. I suspect the debate over these arguments will make the pending bankruptcy reform efforts a lively undertaking.

Remarks of Chief Justice William H. Rehnquist, Annual Spring Meeting of the American Bankruptcy Institute, May 18, 1992, AM. BANKR. INST. BULL., May 20, 1992, at 1.

Articles defending chapter 11 have begun to appear, suggesting that it is now "in play." See, e.g., Easterbrook, *supra* note 2 (arguing that, because chapter 11 endures, it must be efficient); Elizabeth Warren, *Bankruptcy Is a Better Alternative*, NATL. L.J., Apr. 20, 1992, at 15.

7. Bradley and Rosenzweig refer to the Bankruptcy Reform Act of 1978 as the *Act* and to filings as *pre-Act* or *post-Act*. Their usage is disconcerting to both bankruptcy scholars and bankruptcy practitioners who have, for the past 14 years, consistently referred to the pre-1978 legislation as the *Act* and the Bankruptcy Reform Act of 1978 as the *Code*. I employ the terminology that is in common use.

chapter 11. Their strange visions of debtor-creditor relations after repeal of chapter 11 are the unique product of the strange world in which they conduct their analyses. In Part IV, I generalize from the critique of Bradley and Rosenzweig's proposal to a more general critique of the use of perfect market zero transaction cost models in the evaluation of procedures for bankruptcy reorganization and perhaps other legal regimes as well.

I. ARE SOCIAL COSTS HIGHER UNDER CHAPTER 11?

The empirical leg of Bradley and Rosenzweig's argument rests on an apparent anomaly. They show that the companies filing for bankruptcy reorganization since October 1, 1979 (the Code-filing companies)⁸ were, by several measures, financially stronger as they approached bankruptcy than were the companies filing before October 1, 1979 (the Act-filing companies).⁹ The apparent anomaly is that, as the companies approached bankruptcy, the equity and debt securities of the still stronger Code-filing companies lost a larger proportion of their value than did the debt and equity securities of the weaker Act-filing companies.

The difference in the losses was dramatic. Over the two-year period preceding bankruptcy, stockholders of the Act-filing companies lost only a little more than \$.50 per dollar of investment, while stockholders of the Code-filing companies lost nearly all of their investment.¹⁰ In the period beginning twelve months before filing and ending six months after filing, bondholders of the Act-filing companies lost only 42% of their investment while bondholders of the Code-filing companies lost 70% of their investment.¹¹ From these data, Bradley and Rosenzweig reach their direct empirical conclusion that financially stronger Code-filing companies were making smaller distributions to both shareholders and bondholders than financially weaker Act-filing companies. To those familiar with the delivered wisdom of bankruptcy reorganization, this conclusion is startling; the Code procedures for reorganization are generally regarded as vastly superior to the corresponding procedures of the Act.¹²

8. See *supra* note 7.

9. Bradley & Rosenzweig, *supra* note 4, at 1063.

10. *Id.* at 1068.

11. *Id.* at 1072.

12. See, e.g., ELIZABETH WARREN & JAY L. WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 190 (2d ed. 1991) ("[I]t became increasingly obvious that the [Bankruptcy] Act was hopelessly out of date. . . . The bankruptcy system was perceived to be so obsolete [prior to adoption of the Code] that Congress went so far as to make the Rules control over the statute itself in case of conflict."); *id.* at 429 ("A case can be made that the benefits of the new provisions

Bradley and Rosenzweig's argument to the point of their direct empirical conclusion depends upon some questionable inferences.¹³ But the central flaw in their empirical analysis is in their implicit assumption that, by showing that the *bondholders* of Code-filing companies fared worse, they had shown that the *creditors* of Code-filing companies fared worse.¹⁴

Bradley and Rosenzweig describe their empirical exercise in a series of formulae. To understand the significance of their error in treating bondholders as a surrogate for creditors, one need understand only the following definitions and formula:

V = Market Value of Financial Claims¹⁵

E = Earnings Potential¹⁶

F = Filing Frequency

T = Total (Social) Costs of Voluntary Bankruptcy

$$T = F * [E - V]$$

That is, the social costs of bankruptcy are equal to the number of cases, multiplied by the amount lost in each case. In a very general

outweigh the obvious loss of protection for widely scattered and relatively powerless public debtholders and stockholders. The principal benefit might be that companies will enter Chapter 11 earlier and therefore will be healthier and more likely to survive when they do. . . . [T]here may be an important benefit in jobs saved and investments protected.").

13. For example, in using the market values of financial claims from the period approaching bankruptcy as a surrogate for the distributions made to claim holders under chapter 11, Bradley and Rosenzweig implicitly assume that the market correctly anticipated the distributions. In an empirical study of cases under the Act, Altman reached the conclusion that the market systematically overvalued equity shares in the period approaching bankruptcy. EDWARD I. ALTMAN, *CORPORATE BANKRUPTCY IN AMERICA* 79 (1971). Altman's finding provides an alternative explanation for some portion of the relatively high returns to shareholder observed by Bradley and Rosenzweig in Act cases, though its applicability depends on the additional, unproved assumption that the market became more sophisticated about bankruptcy in the 1980s.

I express other reservations about Bradley and Rosenzweig's design *infra* notes 17, 20, and 21.

14. The assumption is introduced in the following passage:

Despite the relative financial strength of [Code-filing] bankrupt firms, both stockholders and *bondholders* of such firms have experienced significantly greater losses in the [Code] period. These results, we believe, suggest that the [Code] has increased management's freedom to pursue self-interested operating strategies at the expense of the firm's security holders. The [Code], in other words, has weakened the ability of *creditors* to monitor management effectively

Bradley & Rosenzweig, *supra* note 4, at 1067 (emphasis added).

Later in their article, Bradley and Rosenzweig list the "stakeholders" in a chapter 11 case. *Id.* at 1056 & n.44, 1088 & n.108. The omission of other kinds of creditors from those lists suggests that Bradley and Rosenzweig considered the bondholders to be representative of creditors generally, and never contemplated that the missing money might in fact have gone to other creditors.

15. In the term *Financial Claims* the authors include both debt claims against, and equity interests in, the company. See *id.* at 1057.

16. The authors use the companies' earnings in the years approaching bankruptcy, as shown by accounting numbers, as a surrogate for the entire stream of income that the company would earn in the future, reduced to present value. See *id.* at 1055-57 & n.45.

sense, the proposition holds intuitively. If the present value of the future earnings of a company facing reorganization (E) is significantly greater than the market value of its debt and equity (V), the market must anticipate that some of those future earnings will never reach the holders of debt and equity. Bradley and Rosenzweig denominated the amount the market expected would go elsewhere as T and called it the Total (Social) Costs of Voluntary Bankruptcy.¹⁷

To avoid the intractable problem of attempting to place a value on future earnings without resorting to market values,¹⁸ Bradley and Rosenzweig adopted a risky empirical strategy. If Filing Frequency and Earnings Potential both increased at the same time that the Market Value of Financial Claims decreased, it would then follow that the Social Costs of Voluntary Bankruptcy must have increased.

Bradley and Rosenzweig had little reason to be concerned about the numbers of filings: it is common knowledge that the filing rate was much higher under the Code than it had been under the Act. That the companies filing under the Code were financially stronger was not common knowledge, but it was at least plausible.¹⁹ Bradley and Rosenzweig presented empirical evidence that it was true.²⁰

17. In so doing, Bradley and Rosenzweig attributed all costs not otherwise accounted for to bankruptcy.

18. Actually calculating the values of the Earnings Potentials of reorganizing companies would have required knowing two unknowable kinds of information: what the future earnings of the companies would have been without the deadweight costs of bankruptcy; and the rate of capitalization the market should apply to those earnings. Bankruptcy scholars and practitioners often express their disdain for attempts to fix these kinds of values in Peter Coogan's pointed epithet that the present value of a future earnings stream is a "guess compounded by an estimate." H.R. REP. NO. 595, 95th Cong., 2d Sess. 222, reprinted in 1978 U.S.C.C.A.N. 5963, 6181, quoted in Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 313 n.62 (1982) (noting that Professor Coogan himself is uncertain whether his phrase was as quoted above or, conversely, "an estimate compounded by a guess" as he is quoted in H.R. REP. NO. 595, 95th Cong., 2d Sess. 225, reprinted in 1978 U.S.C.C.A.N. 5963, 6184).

19. One would expect that, among the companies that actually contemplate bankruptcy, those in the worst financial condition would have the most to gain from filing. Therefore, if the filing rate increased abruptly after adoption of the Code, as it did, the additional filers would presumably be companies not in such bad financial condition that they could benefit from filing under the Act, but in bad enough condition that they could benefit from filing under the Code. There is at least one problem with this assumption: the additional filers may have included some companies in desperate need of bankruptcy relief, but not legally permitted to file for reorganization under the old law. See *infra* note 41 and accompanying text.

20. The evidence is less than entirely convincing. The Bradley and Rosenzweig data show that the earnings of Act-filing companies deviated further below the norm for companies of the Act period than the earnings of Code-filing companies deviated below the norm for companies of the Code period. But the data also show that, as bankruptcy approached, the earnings of Act-filing companies deteriorated at a slower rate than the earnings of Code-filing companies. Bradley and Rosenzweig attribute the sharper decline in Code-filing companies to "management's actual stewardship of the firm in bankruptcy," Bradley & Rosenzweig, *supra* note 4, at 1064 n.60, but that renders their argument somewhat circular. The alternative interpretation is that the Code-filing companies were in weaker financial condition in the sense that their earnings were in

That the Market Value of Financial Claims against reorganizing companies would be lower was the least plausible of the propositions Bradley and Rosenzweig's strategy required them to prove. They began by breaking the problem down into two parts: debt and equity. They then attempted to demonstrate that the market values of both debt and equity of Code-filing companies declined more as bankruptcy approached than did the corresponding values for Act-filing companies. Satisfied that each value had done so, Bradley and Rosenzweig concluded that the sum of the two values must have done so.²¹

Unfortunately, in determining that the value of the *debt* of filing companies had declined, Bradley and Rosenzweig made a classic error in methodology. Its nature is best captured in a joke that empirical researchers like to tell. A Samaritan offers to help in the search for a valuable item on a generally dark sidewalk. Noting that the Searcher is looking only in the small area lighted by a street lamp, the Samaritan asks whether that area is where the Searcher lost the item. "No," the Searcher replies, "but the light is better here." In gathering their data on change in the value of debt claims against the reorganizing companies, Bradley and Rosenzweig looked only where the light was good. That is, they considered only publicly traded debt (bonds). Undoubtedly, their reason for doing so was that market values for the publicly traded debt were published, while market values for other

sharper decline. For another argument that Code-filing companies may actually have been stronger financially than Act-filing companies, see *infra* note 29.

Bradley and Rosenzweig's experimental design rests on the central tenet that the value of a company should be a direct function of its current earnings. Bradley and Rosenzweig infer the increase in social cost in the Code period from the supposedly more rapid increase in earnings than company value from the Act period to the Code period. Bradley & Rosenzweig, *supra* note 4, at 1057-58. Why this tenet should hold for companies with positive earnings is apparent: the higher those earnings, the greater the cash flow likely available to shareholders.

But the "earnings" Bradley and Rosenzweig examined to determine what the companies they studied "should" have been worth were not cash flows at all. They were nearly all losses. *Id.* at 1064 n.59. That is, even though neither company *A* nor company *B* recorded positive earnings, Bradley and Rosenzweig assume that, if the losses of company *B* are higher than the losses of company *A*, the stock of company *B* should sell for less than the stock of company *A*.

It should be obvious, however, that the purchaser of stock in a company that is losing money is not gauging the value of the company principally by its current earnings. So gauged, the value of the company would be negative, and the stock would be worthless. The purchaser of such stock is likely gauging the value of the company principally by the resale value of the company's assets or the positive earnings expected at some future date. That is, the purchaser has concluded that the current losses are *not* a good indicator of the company's future or its value. To assume, as Bradley and Rosenzweig did, that negative earnings alone should be a reasonably accurate predictor of company value is to engage in a leap of faith.

21. Bradley & Rosenzweig, *supra* note 4, at 1057. From the finding that the Market Value of Financial Claims of Code-filing companies declined faster as bankruptcy approached, Bradley and Rosenzweig inferred that the Market Value of Financial Claims of Code-filing companies was lower. In making this inference, Bradley and Rosenzweig implicitly assumed that Market Value of Financial Claims for Code-filing companies and Act-filing companies were equally high at the beginning of the holding periods. The assumption may or may not be warranted.

kinds of debt were not readily available.²² The data Bradley and Rosenzweig collected showed that the market values of the traded debt had decreased; they assumed without commenting that the market values of the nontraded debt had done the same.²³

Substantial reason exists to believe that, if Bradley and Rosenzweig had looked beyond the light of the published trading data, their findings would have compelled them to reach a different conclusion. Table 1 shows the role played by bond financing in the debt structure of the Code-filing companies that Whitford and I studied. Table 2 summarizes key aspects of the data contained in Table 1.

TABLE 1

Amounts are stated in millions of dollars. The data in this table were drawn primarily from the descriptions of debt contained in the plans and disclosure statements filed by these companies with the bankruptcy courts.

	Subordinated Debt		All Other Debt	
	Bonds	Not Bonds	Bonds	Not Bonds
Air Florida				\$304.9
AM International	\$48.6			\$281.7+
Amarex	\$51.4			\$178.6
Anglo Energy	\$18.1			\$122.3+
Baldwin-United	\$38.9		\$108.6	\$292.5
Braniff Airlines	\$25.0		\$49.8	\$1,085.20
Charter Company	\$136.0		\$15.0	\$101.1+
Combustion Equipment		\$13.5		\$213.6+
Continental Airlines	\$73.9			\$607.2
Cook United	\$18.7			\$76.1+
Crystal Oil	\$97.5			\$193.9
Dreco Energy				\$154.9
Energetics				\$96.6
EPIC				\$1,162.0
Evans Products				\$730.0
FSC	\$3.7	\$6.0	\$7.0	\$82.5+
HRT				\$127.7
Itel Corporation	\$123.1		\$110.0	\$1,184.0
Johns-Manville			\$75.0	\$2,727.0+

22. In our recent study of the bankruptcy reorganization of large, publicly held companies, William C. Whitford and I deliberately looked outside the light. With substantial funding from the National Science Foundation and other sources, we developed a methodology for valuing the distributions to nontraded unsecured debt and applied it in 41 of the 43 cases we studied. See Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 135, 141 (1990). To apply those data to prove or disprove Bradley and Rosenzweig's thesis would require a project of similar scope and cost to value distributions in comparable Act cases.

23. See *supra* note 14.

	Subordinated Debt		All Other Debt	
	Bonds	Not Bonds	Bonds	Not Bonds
KDT		\$21.2		\$63.0+
Lionel Corporation	\$13.4			\$143.7+
Marion	\$20.0		\$5.2	\$226.1
McLouth Steel				\$141.4+
MGF	\$99.8			\$127.8+
NuCorp	\$119.1			\$1,003.5
Oxoco	\$48.0		\$4.5	\$111.2
Penn-Dixie Steel	\$19.1		\$3.1	\$27.5+
Phoenix Steel	\$4.0	\$4.8		\$119.0
Pizza Time Theatre	\$51.6			\$84.3
Revere Copper	\$41.2			\$215.3
Salant				\$62.0+
Sambo's Restaurants				\$105.0+
Saxon	\$43.5			\$276.8+
Seatrains Lines	\$47.5			\$292.2
Smith International			\$77.0	\$481.4+
Storage Tek	\$130.9			\$1,242.7
Tacoma Boatbuilding	\$13.0			\$158.6
Technical Equities	\$10.0			\$492.1
Towle Mfg.	\$25.0			\$57.4
Towner Petroleum				\$146.3
White Motor	\$17.2		\$13.7	\$194.6+
Wickes Companies	\$75.9	\$252.4	\$148.1	\$942.0+
Wilson Foods			\$49.7	\$85.8
Totals	\$1,414.1	\$297.9	\$666.7	\$16,521.5+

+ indicates that the amount is understated because the amount for some component (usually secured debt) is unknown

TABLE 2

	Amount in millions	Percent of total
Total bond debt	\$2,544.8	11%
Total nonbond debt	\$16,355.4	89%
		100%
Subordinated bonds	\$1,414.1	68%
Other bonds	\$666.7	32%
		100%

The summary shows that bonds, the only kind of debt examined by Bradley and Rosenzweig, constituted only 11% of the total debt of these companies as they approached bankruptcy. Most of the balance of the debt of these reorganizing companies was in the form of loans from financial institutions such as banks and insurance companies (hereinafter *bank debt*). The summary also shows that most of the

bond debt (68%) was contractually subordinated to the bank debt. That is, at the time the bonds were issued, the purchasers contracted that they would forgo payment during any period the bank debt was in default until the bank debt was paid in full. Thus, the bonds that Bradley and Rosenzweig examined were not only a small portion of the total debt, but a highly atypical portion. Their atypical nature provides the basis for several explanations of the bond value decline observed by Bradley and Rosenzweig that do not support their conclusion of a debt value decline.

The most likely explanation for the sharper decline in bond values in companies approaching Code filing than in companies approaching Act filing is that the bonds of code-filing companies had more leverage working against them. The 1980s were not only the decade of the Code; they were also the decade of the junk bond. Between the Act and Code periods studied by Bradley and Rosenzweig, there was a sharp increase in corporate debt.²⁴ That increase resulted in only a moderate increase in the debt-to-equity ratios of corporations only because it was accompanied by a sharp increase in the market value of the equity of corporations.²⁵ For the companies that filed for bankruptcy, however, the relationship between these increases was different. As Bradley and Rosenzweig report, Code-filing companies were two to five times more highly leveraged in relation to all companies in the junk bond era than Act-filing companies had been in relation to all companies prior to the junk bond era.²⁶ When these sharp deviations of Code-filing companies from the norms of their era are added to the moderate deviation of Code era norms from Act era norms, it becomes clear that the debt-to-equity ratios of Code-filing companies during the 1980s must have been considerably higher than the debt-to-equity ratios of Act-filing companies.

Other factors remaining constant, the effect of higher debt-to-eq-

24. See, e.g., Leland E. Crabbe et al., *Recent Developments in Corporate Finance*, 76 FED. RESERVE BULL. 593, 593 (1990) ("[T]he outstanding debt of the nonfinancial corporate sector soared as corporations borrowed heavily to finance retirements of equity resulting from restructuring activity [during the last half of the 1980s]."); Henry Kaufman, *Debt: The Threat to Economic and Financial Stability*, in DEBT, FINANCIAL STABILITY, AND PUBLIC POLICY: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 15, 18 (1986) ("Over the two years 1984 and 1985, the debt of nonfinancial corporations rose by \$384 billion, while equity contracted by \$99 billion.").

25. Ben S. Bernanke & John Y. Campbell, *Is There a Corporate Debt Crisis?*, 1 BROOKINGS PAPERS ON ECON. ACTIVITY 83, 83-84 (1988); Crabbe et al., *supra* note 24, at 599 ("In particular, the ratio of debt to equity, both measured at market values, has increased only slightly since 1982, as rising equity prices have largely countered the rise in corporate indebtedness." (citation omitted)).

26. Bradley & Rosenzweig, *supra* note 4, at 1094-95 (showing debt-to-asset ratios for Code companies two to five times as high in relation to all firms as the debt-to-asset ratios for Act companies.).

uity ratios will be exactly what Bradley and Rosenzweig observed among Code-filing companies: a faster decline in the value of the subordinated debt and equity as financial problems set in. That is what makes a junk bond junk. To see why, assume that researchers attempting to replicate Bradley and Rosenzweig's study drew a Code sample consisting entirely of companies worth 100, whose senior debt was 90, whose junior debt was 5, and whose shares were worth 5 at the beginning of the holding period. In each case, assume the value of the company decreased by 10 as it approached bankruptcy. Assume each company then reorganized, distributing total value of 90 in accord with the absolute priority rule. All distributions from each of these companies would have gone to the senior creditors; neither stockholders nor bondholders would have received anything. If the market had anticipated the distribution perfectly, the application of Bradley and Rosenzweig's methodology would have yielded findings that the Market Value of Financial Claims had fallen to zero.²⁷ The researchers would have concluded that the Total (Social) Costs of Voluntary Bankruptcy had absorbed the entire value of the company and that the reorganization process had failed completely.

Had the researchers also drawn a sample of Act-filing companies that were less highly leveraged but otherwise the same, Bradley and Rosenzweig's methodology would have yielded a finding that the reorganization procedures of the Act were more "efficient." To illustrate, assume that the Act sample consisted entirely of companies worth 100, with senior debt of 75, junior debt of 5, and shares worth 20 at the beginning of the holding period. Again assume that the values of the companies decreased by 10 as the companies approached bankruptcy. The companies then reorganized, distributing total value of 90 in accord with the absolute priority rule. Stockholders, who received 10, would have lost only half their investment,²⁸ while bondholders would have been paid in full. Though the two sets of companies performed equally well, the Bradley and Rosenzweig methodology would have led the researchers to conclude that the Total (Social) Costs of Voluntary Bankruptcy had been lower for the Act-filing companies.²⁹

27. Recall that the Market Value of Financial Claims is the total value of the stock and debt of the company, *see supra* note 15, and that Bradley and Rosenzweig's methodology measures the value of bonds as a surrogate for the value of debt. *See supra* note 14.

28. *Cf.* Bradley & Rosenzweig, *supra* note 4, at 1068 ("[D]uring the [Act] era, stockholders of firms filing bankruptcy petitions lost a little more than \$.50 per dollar invested over the stated period.").

29. One possible objection to this example is that its assumption that the typical company filing for reorganization was solvent is unrealistic. But Bradley and Rosenzweig's finding that the equity of Act-filing companies lost only half its value in the approach to bankruptcy suggests that many of the companies were in fact solvent. In our study of the largest, publicly held, Code-

Another way of understanding this effect is to realize that subordinated debt is like equity.³⁰ It carries high risk; it represents only the right to what is left after others are paid; and its value depends heavily on the amount of debt to which it has been subordinated. When Bradley and Rosenzweig measured the decline in value of stocks and bonds, they were essentially taking two measures of the fate of equity and leaving the typical debt unexamined.

Greater leverage also explains the apparently more rapid decline in the value of the equity of Code-filing companies. Bradley and Rosenzweig did not measure the decline in the values of the companies, but only in their equities.³¹ Because equity was thinner in Code-filing companies, it seemed to be disappearing more rapidly.³²

Bradley and Rosenzweig considered the possibility that the greater losses suffered by bondholders in the Code era might have resulted from the junk bond phenomenon.³³ They noted, consistently with the argument I present here, that bond rating agencies judged the bonds of their Act-filing companies to have been of significantly higher quality than the bonds of their Code-filing companies. Nevertheless, they rejected the possibility that the Code-filing companies "generally issued 'junk bonds' while their [Act-filing] counterparts issued high-quality bonds" because the Code-filing firms were "financially stronger (and therefore less likely to have to resort to junk bond financings)."³⁴

In reaching this conclusion about the quality of bonds the companies in their study might have issued, Bradley and Rosenzweig appear confused by the odd terminology they employ. They seem to have forgotten that even the "financially stronger" group of Code-filing companies were in fact losing money during the period under study³⁵

filing companies, Whitford and I found that 13 of 43 were solvent in the sense that their shareholders were entitled to a distribution under a strict application of the absolute priority rule. *See* LoPucki & Whitford, *supra* note 22, at 141-43, 164-68. Bradley and Rosenzweig present data showing abnormally high debt-to-asset ratios for companies filing during the Code era, *see supra* note 26, suggesting (contrary to the main thrust of their argument that Act-filing companies were financially weaker) that solvent companies may have been more prevalent among Act-filers.

30. *See* Crabbe et al., *supra* note 24, at 602-03 (arguing that the difference between debt and equity as sources of corporate financing has narrowed significantly during the junk bond era). *See generally* Richard E. Mendales, *The New Junkyard of Corporate Finance: The Treatment of Junk Bonds in Bankruptcy*, 69 WASH. U. L.Q. 1137 (1991).

31. *See* Bradley & Rosenzweig, *supra* note 4, at 1067-68.

32. That is, when the equity of the highly leveraged Code-filing company posited *supra* text accompanying note 27 falls by 10, it registers as a 100% loss. When the equity of the corresponding less highly leveraged Act-filing company posited *supra* text accompanying note 28 falls by 10, it registers as only a 50% loss.

33. *See* Bradley & Rosenzweig, *supra* note 4, at 1072 & n.72.

34. *Id.*

35. *Id.* at 1064.

and were probably not capable of issuing bonds of even junk grade. The bonds dealt with in the reorganization case were almost certainly issued at some earlier point in time. Bradley and Rosenzweig cannot escape this argument by speculating that the Code-filing companies were also stronger before the period covered by the study and therefore less likely to have to resort to junk bond financing; they implicitly postulated that, at the beginning of the period of their study, the two sets of companies were of equal financial strength.³⁶

Perhaps even more importantly, Bradley and Rosenzweig's assumption that the strength of the issuing company is the only determinant of the quality of its bonds is incorrect. Whether the bonds are subordinated, the amount of debt to which they are subordinated, and the total debt load of the company are all important factors in rendering bonds "junk."

Bradley and Rosenzweig's complex empirical design implicitly assumed that the variables they considered were the only ones that changed from the Act era to the Code era. Yet there were probably several other systematic changes that contributed to the observed decline in the distributions to bondholders under the Code. First, some reason exists to believe that publicly traded bonds were less likely to be subordinated during the Act period.³⁷ Thus Bradley and Rosenzweig may, to some extent, have been comparing the returns on senior debt under the Act to the returns on subordinated debt under the Code. Some reason also exists to believe that deviations from the absolute priority rule in favor of shareholders and bondholders have declined between the Act era and the Code era.³⁸ If such a deviation occurred

36. See *supra* note 21.

37. See, e.g., Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 661 (1974):

Chapter X was drawn against a factual backdrop of senior debt held largely by public investors, in opposition to equity investment often drawn from other than widespread public sources. At present the prevailing pattern may be different; holders of senior debt may largely be institutional investors and public investment may be mainly in the form of subordinated debentures or preferred or common stock.

Bradley and Rosenzweig drew their sample of Act cases from the period 1964 to 1979. Bradley & Rosenzweig, *supra* note 4, at 1092. To the extent that the changes described by Blum and Kaplan occurred after the contours of the Bradley and Rosenzweig sample were fixed, the latter's comparison of Act and Code cases compared the returns to senior bonds (under the Act) with the returns to subordinated bonds (under the Code). That the former fare better should hardly be surprising.

Bradley and Rosenzweig's methodology does not address this possibility. They report no attempt to determine what proportion of the bonds they studied were subordinated. They chose to ignore one indication that the bonds of Act-filing companies may have had better covenants: bond rating agencies considered the bonds of their Act-filing companies to have been "of significantly higher quality." *Id.* at 1072 n.72; see *infra* text accompanying notes 33-34.

38. The evidence is sketchy. We report dollar amounts and percentages for the deviations from the absolute priority rule in favor of equity holders under the Code in LoPucki & Whitford, *supra* note 22, at 142. Other empirical evidence illustrates the size of deviations in Code cases.

in the Act company described in the foregoing illustration, the effect would have been to increase the value of the stocks and bonds without increasing the Market Value of Financial Claims or improving in any way the efficiency of Act reorganization.³⁹

Bradley and Rosenzweig's empirical design also assumes that companies with the same earnings *ought* to make the same distributions to creditors and shareholders. That is, from the fact that Code-filing companies with at least the same earnings as Act-filing companies⁴⁰ make lower distributions, Bradley and Rosenzweig conclude that chapter 11 is operating inefficiently. But the relationship between earnings (in these circumstances, the size of the accounting losses being incurred by the company before it enters bankruptcy) and distribution-making capacity (essentially the market value of the company) is loose at best.

The lack of a direct relationship is more than just a theoretical problem with their argument. For reasons entirely unrelated to the efficiency of bankruptcy reorganization, a substantial number of Code-filing companies probably had less distribution-making capacity per dollar of earnings than did Act-filing companies. The flood of compa-

See Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457 (1990) (deviations from absolute priority rule represent 7.6% of total amount awarded to all claimants); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 755 (1989) ("[The results of this study] suggest that . . . there are large deviations from absolute priority."); Julian R. Franks & Walter N. Torous, *How Firms Fare in Workouts and Chapter 11 Reorganizations* 15-16 (September 1991) (unpublished manuscript, on file with author) (finding median deviation from absolute priority rule in favor of equity 1.2% of estimated firm value; average deviation in favor of all security holders 2.7% of estimated firm value).

Unfortunately, there is only anecdotal evidence of the size of deviations in cases under the Act. Theoretically, deviations from absolute priority should have been impossible because the plan was drafted by a court-appointed trustee and had to be approved by the court for compliance with the absolute priority rule. 6A JAMES W. MOORE & LAWRENCE P. KING, *COLLIER ON BANKRUPTCY* ¶ 11.06, at 208-09 (14th ed. 1977). But during the Act era, the Securities Exchange Commission actively participated in chapter X cases and may have been effective in forcing significant deviations in favor of the publicly held securities. Indeed, some argue that chapter X practice deviated from the theory to so great an extent that the consequences were apparent even in the reported cases. See Note, *Absolute Priority Under Chapter X — A Rule of Law or a Familiar Quotation?*, 52 COLUM. L. REV. 900, 909-20 (1952). The involvement of the Securities Exchange Commission has been greatly reduced under the Code. See, e.g., WARREN & WESTBROOK, *supra* note 12, at 428-29.

39. For example, assume that the 90 available for distribution from one of the Act-filing companies in the example *supra* text accompanying notes 27-28 was distributed as follows: 70 to the senior debt, 5 to the junior debt, and 15 to shareholders. Seeing only the 5 and the 15 in the light of the street lamp, by Bradley and Rosenzweig's methodology, the researchers would have concluded that the Total (Social) Costs of Voluntary Bankruptcy had been further reduced because bondholders were still being paid in full while shareholders were now losing only one quarter of their investment.

40. While Bradley and Rosenzweig's data show that the financial losses of Code-filing companies were more abnormally high than the financial losses of Act-filing companies, the differences were minimal. Bradley & Rosenzweig, *supra* note 4, at 1064.

nies that filed under the Code included a type with limited distribution-making capacity that had been partially barred from filing under prior law: terminally ill companies that could not be reorganized but only liquidated.⁴¹ Bradley and Rosenzweig's methodology makes no allowance for this change in the type of company coming into chapter 11; it holds liquidating companies to the same standards as reorganizing companies. When terminally ill Code-filing companies fail to produce as much wealth for shareholders and creditors as reorganizable Act-filing companies with comparable accounting losses before filing, Bradley and Rosenzweig conclude that something is wrong with chapter 11. But, just as last year's tax return may not show that the taxpayer's future earning capacity was sharply diminished by a terminal disease, last year's income statement⁴² for a fatally ill company may not reflect the hopelessness of the company's condition.⁴³ Permitting terminally ill companies to liquidate under the Code, instead of dying quietly outside the light of the street lamp as many presumably did during the Act regime, undoubtedly lowers the ratio of distributions to Earning Potential. But it does not prove the hospital inefficient.⁴⁴

41. Under the Act, the use of Chapter XI to liquidate a company was generally considered improper. The leading case was *In re Pure Penn Petroleum Co.*, 188 F.2d 851 (2d Cir. 1951), in which the court stated:

But notwithstanding the breadth of the definition of an arrangement under Chapter XI, the arrangement must comprehend something more than a mere surrender by the debtor of all his assets for liquidation and distribution to creditors; an arrangement is defined as a "plan of the debtor," but there is no "planning" by a bankrupt in proposing that his creditors be given what the law provides in liquidation under straight bankruptcy.

188 F.2d at 885 (quoting a 1950 edition of COLLIER ON BANKRUPTCY). To be sure, the bar against using chapter XI to liquidate was imperfect. Probably many debtors filed with the full intention of later declaring an "emergency" that would warrant a sale of the business. A large company that sought only liquidation could file under chapter X if management were willing to step aside in favor of a trustee. But the formal bar against filing chapter XI for the purpose of liquidating probably also rendered liquidation less common under the Act.

The Code, on the other hand, specifically authorizes the use of chapter 11 plans that provide for the "sale of all or any part of the property of the estate." 11 U.S.C. § 1123(a)(5)(D) (1988). Under the Code, the use of Chapter 11 to liquidate a company is common. See Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. (forthcoming April 1993) (manuscript at 10-12, on file with author) (liquidations were common in chapter 11; on the average, the companies emerging from chapter 11 were less than one half the size of the companies entering chapter 11).

42. Bradley and Rosenzweig used actual past earnings, as reported in the firm's accounting statements, as the measure of its "Earnings Potential." Bradley & Rosenzweig, *supra* note 4, at 1057 n.45.

43. See *supra* note 20.

44. Admittedly, it does not prove the hospital efficient, either. If liquidations were accomplished without a bankruptcy filing, as Bradley and Rosenzweig advocate, it is possible they would be more efficient. But the decision in 1979 to permit liquidations to take place under the direction of the debtor in possession in chapter 11 was a rejection of that argument. The legislative history does not give reasons for the change. But to those familiar with nonbankruptcy liquidations, the reasons are obvious. Without the supervision of a court, the battle over the remains of a failed company is rife with costly, wasteful strategizing. See generally LYNN M. LOPUCKI, *STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS* 45-136 (2d ed. 1991).

That effects such as these *could* account for Bradley and Rosenzweig's observations does not mean that they *do*. The returns to creditors from financially stronger companies reorganizing under the Code may have been lower than the returns to creditors from weaker Act companies reorganizing under the Act. But Bradley and Rosenzweig's assertion that they have proved it is a gross exaggeration. I have shown at least three more plausible explanations for the sharper decline in stock and bond values in Code-filing cases:

1. Code-filing companies were more highly leveraged.
2. The bonds of Code-filing companies were more likely to be subordinated.
3. Deviations from the absolute priority rule were greater in Act era reorganizations.

In addition, I have shown that the comparability of their samples of Code- and Act-filing companies is suspect because the former includes liquidating companies while the latter does not. Until Bradley and Rosenzweig can establish that creditors, not just bondholders, got less in Code-filing cases, their startling assertion that the Total Social Costs of Voluntary Bankruptcy increased with adoption of the Code simply remains unproved.

II. ARE MANAGERS THE PRIMARY BENEFICIARIES OF CHAPTER 11?

Having satisfied themselves that both shareholders and creditors got less in reorganizations under the Code, Bradley and Rosenzweig turned to the obvious next question: Where *did* the money go? While they equivocate as to whether the money was lost in operations,⁴⁵ was pocketed by the managers themselves,⁴⁶ or disappeared in some ill-defined combination of the two,⁴⁷ they are consistent in asserting that

One of the principal functions of bankruptcy is to control insolvent debtors and prevent fraud. *Id.* at 17-21.

45. For example, they attribute "the costs of court supervised corporate reorganizations" to "one of two suboptimal managerial decisions: the acceptance of negative net present value projects or the rejection of positive net present value projects." Bradley & Rosenzweig, *supra* note 4, at 1052. In other words, they attribute those costs to management's investment decisions.

46. "[T]he means by which [financial economists] imagine that managers extract wealth from bondholders for the benefit of stockholders may well be utilized by managers to expropriate for *themselves* the wealth of both bondholders *and* stockholders." *Id.* at 1051-52. "Presumably, the longer managers can retain control of their firm, the greater the wealth they can extract from the firm's stakeholders." *Id.* at 1075.

47. At one point in the article, they seem to suggest that not all of the missing money was lost through suboptimal managerial decisions: "The costs of these suboptimal managerial decisions are a major component of the social costs of court-supervised corporate reorganizations." *Id.* at 1052. At another, they blur the distinction between the incentives of managers and those of equity holders: "Students of financial economics have long recognized the incentives of corpo-

management are the culprits.⁴⁸ They "conjecture that the [Code's] principal beneficiaries have been corporate managers."⁴⁹

Whitford and I have argued elsewhere that during insolvency, the managers of large, publicly held companies have incentives that frequently discourage them from maximizing the values of their companies.⁵⁰ We also report largely anecdotal evidence to support the charge that these skewed incentives have in fact taken their toll on the value of reorganizing companies.⁵¹ To that extent, our findings and speculations are consistent with those of Bradley and Rosenzweig.

But Bradley and Rosenzweig go an important step further in the charges they level against reorganization managers. They assert that managers benefit from the reduction in the recoveries of stockholders and bondholders. They reach their conclusion based on the implicit assumption of only three players in the chapter 11 game: stockholders, bondholders, and managers. If stockholders and bondholders did worse, managers must have done better.

To the extent that Bradley and Rosenzweig assert that managers extract wealth for themselves, numerous studies contradict them.⁵² Gilson was the first to publish findings that the supposedly omnipotent⁵³ managers of companies in chapter 11 were highly likely to lose their jobs during the case. Bradley and Rosenzweig dismiss Gilson's findings with the assertion that "what matters is not the particular identity of the managers running the firm in bankruptcy reorganization, but rather the latitude (and incentive) these managers have under

rate managers (equity holders) to effect wealth transfers from bondholders by embracing value-decreasing operating strategies." *Id.* At a third, they seem to be suggesting that suboptimal managerial decisions enable managers to keep their jobs. See *infra* note 48.

48. Bradley & Rosenzweig, *supra* note 4, at 1050 ("[T]he data show that Chapter 11 preserves and protects the jobs of corporate managers, not corporate assets.").

49. *Id.* at 1076.

50. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. (forthcoming Jan. 1993) (manuscript on file with author).

51. *Id.*, manuscript at 3-4, 72-74, 81-83.

52. See Brian L. Betker, *Management Changes, Equity's Bargaining Power and Deviations from Absolute Priority in Chapter 11 Bankruptcies* (Mar. 1992) (unpublished manuscript, on file with author) (finding high CEO turnover during chapter 11 reorganization); Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355 (1990); LoPucki & Whitford, *supra* note 50, at 64-70 (finding high CEO turnover during chapter 11 reorganization); Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms* (Sept. 1992) (unpublished manuscript, on file with author) (finding incumbent CEOs experience large reductions in their real cash compensation after default, while new CEOs hired from outside the firm receive large increases in cash compensation relative to the CEOs they replace).

53. Throughout their article, Bradley and Rosenzweig paint a picture of management as having tremendous power and independence from creditors. For example, they assert that "[f]iling a Chapter 11 petition, in effect, is a way to keep control of the firm free from the intrusive monitoring of creditors." Bradley & Rosenzweig, *supra* note 4, at 1076.

Chapter 11 to pursue suboptimal strategies.”⁵⁴ If by that they mean that the replacement managers will have the same independence from creditors that their predecessors had, more recently published research again contradicts them. Both Betker and Whitford and I have documented heavy creditor involvement in the sacking of these managers.⁵⁵ Whitford and I found that, once in office, many of the replacement managers align with creditors.⁵⁶ Contrary to Bradley and Rosenzweig’s assertion that the reorganization managers are “actors who do not suffer the economic consequences of their actions,”⁵⁷ the managers of reorganizing companies appear considerably more vulnerable to their constituencies than the managers of healthy companies.⁵⁸ A substantial minority of them make their livings as professional turnaround managers. They move from financially distressed company to financially distressed company, competing for their positions on the strength of their reputations.⁵⁹ Creditors usually play a substantial role in their selection.⁶⁰ Gilson and Vetsuypens found that these managers, whose compensation was fixed in a competitive market, earned more than the managers who held onto their offices by means of the chapter 11 filing.⁶¹

Bradley and Rosenzweig offer no explanation as to *how* managers “expropriate for *themselves* the wealth of both bondholders and stockholders.”⁶² During our study of the bankruptcy reorganization of

54. *Id.* at 1077 n.77.

55. See Betker, *supra* note 52; LoPucki & Whitford, *supra* note 50, at 64-70.

56. LoPucki & Whitford, *supra* note 50, manuscript at 78.

57. The passage reads: “[T]he principal deficiency of the existing law of corporate bankruptcy is that it leaves corporate control for *some period* in the hands of actors who do not suffer the economic consequences of their actions. Professor Gilson’s findings do not suggest otherwise.” Bradley & Rosenzweig, *supra* note 4, at 1077 n.77.

58. LoPucki & Whitford, *supra* note 50, manuscript at 30-60, 64-74.

59. *Id.*, manuscript at 54-55 & nn.169, 171.

60. *Id.*, manuscript at 54-55.

61. Gilson and Vetsuypens found that incumbent CEOs experienced large reductions in their real cash compensation when their companies went into default and that new CEOs hired from outside the firm received large increases in cash compensation relative to the CEOs they replaced. See Gilson & Vetsuypens, *supra* note 52, at 1, 15-16.

62. Bradley & Rosenzweig, *supra* note 4, at 1052. In their brief economic analysis, *id.* at 1050-54, Bradley and Rosenzweig referenced the literature of financial economics for the proposition that, by engaging in risky investments, managers can extract wealth from bondholders for the benefit of stockholders. Based on their finding that stockholder wealth *declined* under the Code, however, Bradley and Rosenzweig concluded that the financial economics literature must have “mis-specified the conflict.” *Id.* at 1051. They propose the alternative theory that the managers expropriated the wealth of stockholders and bondholders for themselves. *Id.* at 1051-52. They do not, however, even attempt to explain what the mechanics of that expropriation might have been. At times, they seem to suggest that “expropriate for themselves” does not mean that the managers captured the value, but rather that the value was lost through suboptimal investment decisions. See *supra* note 45.

large, publicly held companies, however, Whitford and I examined the compensation and other benefits that managers extracted from their companies.⁶³ Our examination included the plans and disclosure statements, the companies' SEC disclosures, articles in newspapers and trade journals, more than 120 interviews with lawyers who played key roles in the cases, and other sources. We specifically searched for the kinds of self-serving behavior that Bradley and Rosenzweig imagine. While we found several incidents in which managers held up their companies for additional and probably excessive compensation⁶⁴ or won releases from liability for their own wrongdoing,⁶⁵ the amounts involved were only a tiny fraction of the amounts that Bradley and Rosenzweig report missing. If the managers are expropriating for themselves the wealth of bondholders and stockholders, they are doing it by means that neither we nor the financial writers who covered these forty-three cases were able to detect. Bradley and Rosenzweig's image of managers as "actors who do not suffer the economic consequences of their actions" appears no more applicable to companies in financial distress than to those that remain in good health.

III. CAN THE "MARKET" SUBSTITUTE FOR CHAPTER 11?

Bradley and Rosenzweig do not purport to base their provocative call for the repeal of chapter 11 on their empirical findings. They acknowledge that the direct implication of their finding that reorganization under the Act was more efficient than reorganization under the Code is that Congress should repeal chapter 11 in favor of the former law.⁶⁶ It is on the basis of their nonempirical economic analysis that they conclude that court-supervised bankruptcy reorganization should

63. See LoPucki & Whitford, *supra* note 50, manuscript at 70-74.

64. See *id.*

65. See *id.*

66. Bradley & Rosenzweig, *supra* note 4, at 1077 n.80 ("Strictly speaking, therefore, our data support repeal of Chapter 11 *in favor of the previous Chandler Act regime*, but not necessarily outright abolition of court-supervised corporate reorganization.").

Bradley and Rosenzweig make a second unwarranted extension of their data and analysis when they recommend repeal of chapter 11 for all companies based on data and analysis relevant only to large, publicly held companies. From 1981 through 1990, only 942 publicly held companies filed under chapter 11. See Securities Exchange Commission, *Public Companies Filing Chapter 11 Petitions* (on file with author). Those filings constituted only one half of one percent of the 194,135 chapter 11 cases filed during those years.

be eliminated entirely.⁶⁷

The heart of that analysis lies in the concluding section, appropriately entitled "The Perfect Markets Solution to the Chapter 11 Dilemma." There the authors demonstrate that in the "hypothetical world of perfect markets" the problems of bankruptcy reorganization disappear, and "there is no economic justification for judicial interference in the contractual relationship between corporate creditors and debtors."⁶⁸ Though the section seems on its face to have been written

TABLE 3
Total cases filed under Chapter 11 during the years 1981-1990
Involuntary cases were listed separately in 1981-1982

Year	Ch. 11s	Page	Involts	Page
1981	9,881	A-72	160	A-74
1982	18,543	A-62	278	A-64
1983	20,252	A-60	n/a	n/a
1984	20,252	A-60	n/a	n/a
1985	23,374	A-78	n/a	n/a
1986	24,740	68	n/a	n/a
1987	19,901	70	n/a	n/a
1988	17,690	68	n/a	n/a
1989	18,281	60	n/a	n/a
1990	20,783	60	n/a	n/a
	193,697		438	194,135

See ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, FEDERAL JUDICIAL WORKLOAD STATISTICS (1981-1990). Bradley and Rosenzweig acknowledge that their data are limited to publicly held companies but assert that their theoretical analysis arguably applies with equal force to private companies and challenge those who would limit them to demonstrate why the data for private companies, if available, would differ from the data for public companies. See Bradley & Rosenzweig, *supra* note 4, at 1077 n.80.

The answer to their challenge is that their proposal relies at every turn on the existence of efficient capital markets for both debt and equity. *E.g., id.* at 1081. The lack of data for private companies results from the fact that such markets are virtually nonexistent. Bradley and Rosenzweig attempt to assert that such markets are developing. See *id.* at 1081 n.87. But their examples of the "small" companies whose debt and equity have piqued the interest of speculators are actually examples of relatively large companies in comparison with the vast majority of companies that currently reorganize under chapter 11. For a sense of just how small the small companies are, see EXECUTIVE OFFICE FOR U.S. TRUSTEES, U.S. DEPT. OF JUSTICE, AN EVALUATION OF THE U.S. TRUSTEE PILOT PROGRAM FOR BANKRUPTCY ADMINISTRATION 47 (1983) [hereinafter ABT STUDY] (showing the median assets of 236 companies reorganizing in U.S. Trustee pilot districts to have been \$313,000 and the median assets of 253 other companies reorganizing in nonpilot districts to have been \$205,000); Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 203-04 (1987) (showing the median assets of 48 companies reorganizing in the Eastern District of Wisconsin about 1983 to have been \$318,983); Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99, 120-21 (1983) (showing the median assets of 48 companies reorganizing in the Western District of Missouri about 1980 to have been \$344,363).

Bradley and Rosenzweig do not indicate the size of the companies they studied, but the median asset size of 49 publicly held companies filing under chapter 11 from October 1, 1985 to October 1, 1986 was \$10.9 million. Securities Exchange Commission, Public Companies Filing Chapter 11 Petitions (on file with author).

67. "In our view, however, reinstatement of the Chandler Act would be only a second-best solution; our economic analysis in Part II strongly suggests that the *best* solution would be to eliminate corporate bankruptcy reorganization entirely, in favor of our proposal." Bradley & Rosenzweig, *supra* note 4, at 1077 n.80.

68. *Id.* at 1053, 1054.

facetiously, the authors never crack a written smile. Instead, "building on the perfect markets solution to the Chapter 11 dilemma,"⁶⁹ they propose the repeal not only of chapter 11⁷⁰ but of all other forms of court-supervised reorganization.⁷¹

According to Bradley and Rosenzweig, in the world that would follow, the financially distressed company would face no day of reckoning. Instead, when the company needed money to pay its debts, it would sell additional stock. Unless the firm was insolvent someone would always buy the stock.⁷² If the firm was insolvent, it would default, and the existing residual claimants (shareholders) would give up all claims to its value. They would be ousted from control of the firm immediately,⁷³ without judicial intervention.⁷⁴ Control would pass to next higher priority class, who would become the new shareholders.⁷⁵

To those not already familiar with the economist's hypothetical world of perfect markets and zero transaction costs (hereinafter *the PM-ZTC World*),⁷⁶ this description must seem strange. But Bradley and Rosenzweig's strange visions do in fact follow from the strange assumptions upon which the PM-ZTC World is based. In their attack on chapter 11, Bradley and Rosenzweig have pushed those assumptions to their limits and demonstrated again how great are the differences between the world in which we live and the world in which so many economists do their thinking. A comparison of four problems

69. *Id.* at 1077.

70. *See id.* at 1088-89.

71. *See id.* at 1078.

72. *See infra* note 79.

73. Bradley & Rosenzweig, *supra* note 4, at 1086.

74. *Id.* at 1085. Bradley and Rosenzweig qualify their statement by noting: "Of course, the courts would retain their traditional role of enforcing property rights and contracts." *Id.* at 1085 n.97. They cannot mean that the state courts will remove managers from office after they resolve disputes regarding default, because such removal would be far from "immediate" as they promised. *Id.* at 1086 ("[T]he common equity holders would be ousted from control of the firm immediately upon the firm's default . . ."). But neither can they mean that the state courts will remove managers without resolving disputes. They more probably have relied on the assumption that, in the absence of transaction costs, parties will reach an agreement that maximizes joint wealth. *See infra* note 118 and accompanying text. Under that assumption, the dispute would be resolved immediately, and the agreement itself would accomplish removal.

75. Bradley & Rosenzweig, *supra* note 4, at 1084.

76. In deciding to refer to this world as the PM-ZTC World, I have rejected the more commonly used *Never-Never Land*. *See, e.g.,* Bruce A. Ackerman, *Law, Economics, and the Problem of Legal Culture*, 1986 DUKE L.J. 929, 935 ("The Priest-Rubin result obtains only in the never-never world of neoclassical economics, in which there are no transaction costs . . ."); Bruce A. Ackerman, *Foreword: Law in an Activist State*, 92 YALE L.J. 1083, 1109 (discussing "a world very close to Coase's never-never land"); Robert C. Ellickson, *The Case for Coase and Against "Coaseanism"*, 99 YALE L.J. 611, 613 (1989) (discussing "never-never-world of zero transaction costs").

addressed by chapter 11 and Bradley and Rosenzweig's PM-ZTC solutions to those problems will illustrate my point.

1. *Illiquidity.* In traditional bankruptcy theory, an asset is said to be "illiquid" when its value cannot easily be converted to cash. If the owner is forced to sell an illiquid asset under pressure of time, in a market in which there are too few buyers, or to buyers who must make major expenditures to evaluate the asset, the sale price may be considerably less than the actual value of the asset. For example, state court judicial sale procedures are widely recognized to result in sales at prices that frequently are below the "market" value of the asset.⁷⁷ Chapter 11 addresses the deficiencies of the marketplace by offering the owners, and more importantly the creditors, an alternative to putting the debtor's assets on the auction block. By reaching an agreement among themselves that relieves the company's financial distress, the debtor and creditors may be able to avoid the necessity for a costly sale at a depressed price.

In the PM-ZTC world, the problem of illiquidity does not exist. Because the markets are assumed to be perfect, anything that has value can be sold for that value, immediately and costlessly. A corollary to that proposition is that, if an asset cannot be sold for its putative value of \$X, it does not have that value. Perhaps the sharpest difference between the PM-ZTC World and the world of traditional bankruptcy theory regards initial public stock or bond offerings. In the latter world, making an initial public offering of securities in a financially distressed company is virtually impossible.⁷⁸ But in the PM-ZTC World, one can make an initial public offering to save a company from financial disaster, to make the company's monthly pay-

77. See, e.g., *Barrett v. Commonwealth Fed. Sav. & Loan Assn.*, 939 F.2d 20 (3d Cir. 1991) (finding that foreclosure sale of debtor's home for between 69.5% and 77.6% of its "fair market value" compared favorably with the typical foreclosure sale in the area).

78. In our study of the largest 43 companies to reorganize through chapter 11 in the period from October 1, 1979 to March 15, 1988, Whitford and I found that none resolved its financial crisis by means of an initial public offering. See LoPucki & Whitford, *supra* note 50, at 97; see also Dwight Cass, *Street Expects Flurry of Post-Restructuring IPOs in the 1990s*, CORP. FINANCING WK., June 3, 1991, at 1 (discussing the use of public offerings by creditors after the debtor company has emerged from chapter 11 and quoting James Harris, managing director and head of Lehman Brothers' financial restructuring group, as saying, "You need a situation that will look to investors like a normal, well-capitalized company"); Gretchen Morgenson, *From Bust to IPO*, FORBES, Oct. 30, 1989, at 14 (noting that Cable Applications, Inc.'s initial public offering while in chapter 11 "may be a first on Wall Street"). For a case in which a debtor attempted unsuccessfully to emerge from Chapter 11 through a public offering, see *Conforte v. United States*, 125 B.R. 287 (D. Nev. 1991), discussed in United Press International, *Federal Trustee Says Brothel Could Reopen Thursday or Friday*, Sept. 19, 1990 (reporting two failed attempts by the Mustang Ranch to emerge from chapter 11 through the making of a public offering of stock) (available on NEXIS).

ments,⁷⁹ or to buy a chocolate bar. The assumption of perfect markets enables Bradley and Rosenzweig to reach the conclusion that, in the PM-ZTC World, when management can no longer raise capital through the sale of stock, the debts of the company exceed the value of its assets.⁸⁰

2. *Communication and coordination.* During the bankruptcy reorganization of large, publicly held companies, a great deal of time and effort goes into coordinating the activities of the thousands of stakeholders. Within the scheme of intermediation⁸¹ laid down by chapter 11, the parties struggle over the appointment of official committees,⁸² the precise groups the committees will represent,⁸³ and the information resources they should have.⁸⁴ Communication is difficult.⁸⁵ Merely to send a formal notice to the creditors and shareholders themselves may cost hundreds of thousands of dollars and take several months. Direct negotiations among so many parties are

79. Bradley & Rosenzweig labor over a precise statement of whether the debtor would make a public offering to obtain the money necessary to make particular debt payments that are due: If [the value of the firm's equity after making the payment is greater than the amount of the payment that is due], then there is positive net equity in the firm and, assuming an efficient capital market, managers could issue new equity shares to finance the debt payments that are currently due. If [that expression] does not hold, then there is no equity in the firm, and managers could not sell new equity to finance the current debt payments . . .

Bradley & Rosenzweig, *supra* note 4, at 1082 (footnote omitted).

80. *See id.*

81. *See* LoPucki & Whitford, *supra* note 22, at 154-85.

[R]eorganization plans are not directly negotiated by the parties in interest, but rather by intermediaries functioning as the parties' representatives. The effects of intermediation are compounded by perplexing layers of agency. For example, a public bondholder may be represented in the chapter 11 case by an indenture trustee, which is usually the trust department of a bank. The bank may retain a member of a private law firm to conduct the representation. If the indenture trustee is appointed to membership on the unsecured creditors' committee, the lawyer may be the one who attends the meetings. The committee will retain a bankruptcy lawyer to represent itself in negotiations with the debtor and the representatives of shareholders.

Id. at 154.

82. In three of the 43 cases (7%) that Whitford and I studied, equity holders were defeated in bids to form equity committees. LoPucki & Whitford, *supra* note 22, at 191. Committee status is worth struggling over; it assures that the group represented will be present at the bargaining table and virtually assures that the group will share in the distribution under the plan, even in the complete and obvious absence of a legal entitlement. *See id.* at 158-60, 190-93.

83. Even though the unsecured creditors' committee represents the holders of subordinated debt in the absence of a separate committee, investors who acquire substantial holdings in the subordinated debt of reorganizing companies typically seek the formation of a separate committee to represent only the subordinated debt. *See id.* at 160-63.

84. For example, creditors' committees generally succeed more often than do equity committees in winning the right to retain financial advisers to assist them in the process of plan formulation. LoPucki & Whitford, *supra* note 50, at 118 & n.334.

85. For an illustration of the difficulty of communicating with large numbers of stakeholders, see *In re Southland Corp.*, 124 B.R. 211, 220-23 (Bankr. N.D. Tex. 1991) (discussing whether and how securities dealers who hold bonds for customers notify the customers of the vote and the problems of authority created when the securities dealers attempt to vote the bond for or against a plan of reorganization).

unthinkable.⁸⁶

Under the assumptions of the PM-ZTC World, these problems also disappear, enabling thousands of corporate stakeholders to act virtually as one. Without transaction costs, both communications and negotiations are free and instantaneous. The predominant strain of the PM-ZTC World, utilized by Bradley and Rosenzweig, assumes that parties always accept proposals that are in their interests.⁸⁷ This powerful assumption enables Bradley and Rosenzweig to propose that each of a debtor's creditors be entitled to have its own contract governing the firm's operating strategies and to "strictly enforce" it.⁸⁸

In a world with transaction costs, debtors might well inadvertently⁸⁹ or strategically⁹⁰ agree to contracts whose inconsistencies precluded their simultaneous strict enforcement. Indeed, sorting out inconsistencies among the rights of competing creditors is frequently cited as one of the primary purposes of chapter 11.⁹¹ But Bradley and Rosenzweig correctly surmised that in the PM-ZTC World any incon-

86. For an account of the complexity of a negotiation involving approximately 400 banks, see MICHAEL MORITZ & BARRETT SEAMAN, *GOING FOR BROKE: THE CHRYSLER STORY* 297-318 (1981). The Chrysler negotiations could be limited to the 400 banks because the negotiators were willing to accept a deviation from the absolute priority rule; they permitted the nonbank creditors, who had equal priority with them, to be paid in full in the ordinary course of business. Under Bradley and Rosenzweig's proposal, no such limiting would occur. Their proposal would "ensure adherence to the rule of absolute priority by precluding payments to junior claimants when senior claims are not fully paid." Bradley & Rosenzweig, *supra* note 4, at 1085. This, they tell us, "would eliminate uncertainties currently associated with the reorganization process and thereby increase the utility of risk-averse investors, who would be willing to pay a premium for the certainty afforded by strict application of the absolute priority rule." *Id.* (footnote omitted).

87. Critics of the Coase Theorem have called into question Coase's assumption that parties will always settle merely because it is in their interest to settle. Coase has responded that "there is good reason to suppose that the proportion of cases in which no agreement is reached will be small." RONALD COASE, *THE FIRM, THE MARKET AND THE LAW* 161 (1988); see Stewart Schwab, *Coase Defends Coase: Why Lawyers Listen and Economists Do Not*, 87 MICH. L. REV. 1171, 1174-78 (1989) (reviewing COASE, *supra*). Abandonment of the assumption that parties will make the deals they should make, even if they are in a bilateral monopoly, would deflate Bradley and Rosenzweig's argument, even in the PM-ZTC World. Chapter 11 would be necessary to impose on irrational parties the deals they should have made. See, e.g., *supra* note 74 and accompanying text.

88. Bradley & Rosenzweig, *supra* note 4, at 1087.

89. In small transactions, debtors might be beaten in the "battle of the forms." That is, they might be bound to provisions contained in unread boilerplate on purchase orders or other contract documents. In large transactions, debtors might misinterpret particular contract provisions as consistent when they were not.

90. For example, a debtor that needed a loan and could not get it any other way might conceal conflicting contractual obligations from a prospective later lender.

91. See, e.g., JACKSON, *supra* note 2:

The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse.

Id. at 10.

sistency among the agreements could easily be resolved by further agreement when the inconsistency came to light. In that world, to talk of managers "approach[ing] debtholders to strike a mutually advantageous bargain" to accept particular investment projects is entirely realistic,⁹² even though debt holders number in the thousands and none can be bound without its consent. In the PM-ZTC World, the parties could know in advance that, at the time of the renegotiation, any parties with inconsistent rights would agree on a course of action that maximized the group's joint wealth and divided that wealth among them in a manner that left everyone better off.⁹³

3. *Relief from contractual default provisions.* Another important function of chapter 11 is to relieve debtors from the sometimes draconian provisions of loan agreements that specify the effects of default. Bradley and Rosenzweig tell us that, under their proposal, enforcement of the creditor's bargain would occur automatically upon default. That is, the law they would have Congress adopt in place of chapter 11 "would leave . . . the definition of default to contracts . . . between the company and its claimholders,"⁹⁴ and provide "for automatic cancellation of residual claims [shareholdings] in the event of default."⁹⁵ They apparently mean that if any⁹⁶ contract with a creditor goes into default, the common stock of the company will, to use their word, "evaporate."⁹⁷ Readers who fall into the trap of analogizing to the world in which they live might be concerned about the possibility that a PM-ZTC World debtor might default on a single, small debt, thereby converting the remainder of the company's debt to stock, perhaps to the great distress of the latter's owners.⁹⁸ In the PM-ZTC

92. Bradley & Rosenzweig, *supra* note 4, at 1088 n.107.

93. See *infra* note 118 and accompanying text.

94. Bradley & Rosenzweig, *supra* note 4, at 1078.

95. *Id.*

96. My conclusion that Bradley and Rosenzweig contemplate that a single default would trigger evaporation of the stock rests on the following passages: "This repeal of Chapter 11 would permit corporate claimants to enforce these contracts strictly in the event of default, since the law would no longer provide for a stay of enforcement actions in that event." *Id.* at 1078. (Chapter 11 provides a stay that applies to, and can be lifted with regard to, each creditor separately. 11 U.S.C. § 362(a), (d) (1988)). "A critical feature of our proposal, however, is that *each* creditor would be able to bind the firm to strictly enforceable default-contingent contracts." *Id.* at 1084 n.94. Had they contemplated that only defaults in particular kinds of debts would trigger the cancellation, Bradley and Rosenzweig would have faced the problem of providing a remedy through which to enforce the debt that could not trigger cancellation.

97. "[F]or all intents and purposes, the firm's equity securities will 'evaporate.'" *Id.* at 1082. In the PM-ZTC World, this should not be cause for alarm. Things often go in and out of existence quite suddenly.

98. In the PM-ZTC World, whether one owns debt or equity does not matter. One can be exchanged in the perfect market for an equivalent value of the other, without incurring transaction costs. But actual debt holders often exhibit a strong preference to remain in that status. See Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L.

World, however, that could not happen. First, because any default would evaporate both the shares of the company and the tenure in office of the managers, managers would put off default as long as possible. All debts would go into default simultaneously.⁹⁹

Second, even if default happened otherwise, it would not matter. For example, some bookkeeper's oversight in failing to mail a check on time could evaporate billions of dollars of stock of a Fortune 500 company. In a world with transaction costs, that might throw the affairs of both the company and its shareholders into chaos. But, because chaos is not Kaldor-Hicks Pareto Optimal,¹⁰⁰ in the PM-ZTC World it is not a possible state of affairs. If a disorderly evaporation were to occur,¹⁰¹ it would be only momentary. Again, the PM-ZTC assumption that parties always agree to what is in their interests saves the day. The creditors and shareholders would promptly meet and use their complete information¹⁰² to select a Pareto Optimal state for the group. That state might be a waiver of the default accompanied by condensation¹⁰³ of managers and stock. Alternatively, it might leave them in their gaseous state and recapitalize the company. In the PM-ZTC World, what capital structure was created would not matter; one would be as good as another.¹⁰⁴

4. *Soft landings for managers and shareholders.* In the world of imperfect markets and transaction costs, extricating the productive resources of a failed business from the managers and owners who presided over the failure can be difficult. Failed owners and managers

REV. 527, 532 (1983) (arguing that creditors' preference for debt rather than equity is so great that it frequently causes reorganizing companies to issue more debt than they can pay).

99. Bradley and Rosenzweig consistently refer to default as an event that occurs with regard to a class of debt rather than a single creditor. See, e.g., Bradley & Rosenzweig, *supra* note 4, at 1079-88.

100. See generally Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549 (1939).

101. The subjunctive is employed to indicate that it is in fact impossible. Bradley and Rosenzweig correctly describe the PM-ZTC World default process as follows:

[T]he elimination of the firm's equity holders and the erosion of their holdings would be a slow, orderly process.

Because of this feature, our proposal would also obviate the need for an automatic stay [U]nder our proposal there would be little, if any, concern that nervous creditors would race one another to the courthouse in order to convert their claims into priority judgments against a firm on the verge of "failure."

Bradley & Rosenzweig, *supra* note 4, at 1085 & n.98.

102. In a world without transaction costs, it is feasible to obtain all relevant information. "Thus," in the world imagined by Bradley and Rosenzweig, "at every point in time, capital market agents would be evaluating the firm's securities in light of the promised payments and the distribution of terminal values. Market participants would continually assess the firm's need and ability to issue new shares to meet its debt obligations." *Id.* at 1085.

103. The reverse of evaporation.

104. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

commonly cling to their positions, dispute default on bases both real and imagined, and hunker down in place until the appeals have been exhausted and the sheriff comes to eject them on the day of reckoning. Particularly bitter ones sometimes lay waste to everything they cannot take with them as they begin to evaporate.¹⁰⁵ Whitford and I have argued elsewhere that chapter 11 plays a crucial role in removing failed management and shifting ownership and control of large, publicly held companies to their true residual owners.¹⁰⁶ It does these things in a manner that is emotionally less than satisfying¹⁰⁷ but strikingly effective. Tainted managers are nearly certain to be removed;¹⁰⁸ control of an insolvent company almost invariably changes hands.¹⁰⁹

Bradley and Rosenzweig assert that, under their proposal, the ouster of management from control of the failed company would occur immediately on default,¹¹⁰ without the need for judicial intervention,¹¹¹ leaving the sacked managers without the leverage needed to negotiate a deviation from the absolute priority rule.¹¹² Here, too, their characterization of life in the PM-ZTC World is accurate. That world features no day of reckoning,¹¹³ no disputing,¹¹⁴ and no ability

105. See, e.g., *In re KenDavis Indus. Intl.*, 91 B.R. 742, 750 (Bankr. N.D. Tex. 1988) ("Mr. Davis instructed Locke Purnell to lay waste to all, unless the banks agreed to his terms of settlement. He dictated a war of 'scorched earth' leaving what remained after the battle to the institutional creditors.").

106. See LoPucki & Whitford, *supra* note 50, at 78-81; LoPucki & Whitford, *supra* note 41, at 17-19.

107. The current system by which failed managers are removed from office is both erratic and unprincipled. Depending on their sense of timing and their skills, some of the failed managers of the large, publicly held companies Whitford and I studied were able to "sell" their resignations to the companies' stakeholders in return for generous severance packages and releases for their misconduct, while others were forced out of office and subjected to both civil and criminal litigation. LoPucki & Whitford, *supra* note 50, at 70-74.

108. Whitford and I found that 95% of CEOs who led their companies into financial distress were out of office by the end of the chapter 11 case. *Id.* at 66-67.

109. LoPucki & Whitford, *supra* note 41, at 17-19. In all but two of 30 insolvent companies studied, controlling blocks of shares were issued to creditors. *Id.* at 30-31.

110. "[T]he common equity holders would be ousted from control of the firm immediately upon the firm's default on its obligation to pay senior creditors." Bradley & Rosenzweig, *supra* note 4, at 1086.

111. See *supra* note 74.

112. "In addition, our proposal would ensure adherence to the rule of absolute priority by precluding payments to junior claimants when senior claims are not fully paid." Bradley & Rosenzweig, *supra* note 4, at 1085.

113. Under our proposal, there would be no "day of reckoning" and no need for a court-supervised sale or recapitalization of the firm. Rather, as the market learned more about the distribution of terminal values, the values of the firm's securities and its contingent securities would adjust accordingly. Thus, the elimination of the firm's equity holders . . . would be a slow, orderly process.

Id.

114. See *supra* note 74 and accompanying text.

to resist the determination of the Market.¹¹⁵ As they point out, the destruction of value (as opposed to the threat of such destruction) is flatly impossible.¹¹⁶ The creditors and the would-be destroyer reach an agreement that preserves the property and divides the resulting increase in wealth between them in such a way that both are better off than if the property had been destroyed.¹¹⁷

Chapter 11 exists solely to deal with transaction costs. It should be apparent by now that Bradley and Rosenzweig are correct in their conclusion that there is no need for court-supervised reorganization in a world without transaction costs. A perfect market would be a perfect substitute for chapter 11; in a PM-ZTC world, chapter 11 *should* be repealed. The issue is what significance should be accorded conclusions from the PM-ZTC World in evaluating proposals for reform of the world in which we live.

IV. MOVING BETWEEN WORLDS

Bradley and Rosenzweig's economic analysis of bankruptcy reorganization tells us more about economic analysis than about bankruptcy reorganization. The way problems melt away in this PM-ZTC World seems at first elegant, then suspicious, and finally boring. Every new proposal seems to maximize societal wealth.

The reason is simple. In this strange PM-ZTC World, every new proposal *does* maximize societal wealth. The explanation is captured most concisely in the Coase Theorem: In the absence of transaction costs, parties will reach an agreement that maximizes joint wealth.¹¹⁸ From this Theorem is derived the invariance thesis: The parties involved in a particular legal system (imaginary world) will reach the same efficient result regardless of initial legal entitlements.¹¹⁹ Though the deal making necessary to eliminate inefficiencies may shift wealth among the bargaining parties, it eliminates the inefficiencies perfectly and completely. No matter what rule or structure is legislated, when

115. One must always maximize one's utility. See *infra* note 126.

116. "In this hypothetical world of perfect markets, valuable firm-specific capital could never be destroyed." Bradley & Rosenzweig, *supra* note 4 at 1053.

117. Bradley and Rosenzweig do not attempt to explain how the immediate ouster they promise would come about. The method described here is my own conjecture.

118. Coase himself never directly stated the Theorem, with the result that it appears in several versions. This one comes from Schwab, *supra* note 87, at 1174.

119. See *id.* at 1178. The invariance thesis is sometimes referred to as the strong version of the Coase Theorem. While it ignores the fact that wealth effects could feed back to affect the precise nature of the efficient result achieved, in the context of the reorganization of large, publicly held companies, that qualification is insignificant. Wealth effects are most likely to feed back when they give weight to a particular group's preferences regarding consumption. *Id.* at 1178-83.

the deal making is over, that rule or structure maximizes societal wealth just as well as any other.

Unfortunately for Bradley and Rosenzweig in their call for repeal of chapter 11, the Theorem means not only that the same amount of smoke would be released from the factory's chimney whether the factory owner or the householder were legally responsible for the smoke damage,¹²⁰ but also that the most efficient course will be taken to reorganize a company, whether the law entitles managers to hide themselves and their companies from creditors in chapter 11 or not. Answers to complex social and economic problems flow so easily in a world without transaction costs that anybody who proposes doing *anything* about a perceived problem can easily be bested. Whatever is (or can be imagined), is efficient.¹²¹

The proof for the besting of Bradley and Rosenzweig proceeds as follows. If, in the PM-ZTC World, chapter 11 imposed large social costs on creditors through inefficient operation of the business and looting by management, the debt collection *system* would still operate with perfect efficiency. Creditors would simply bribe¹²² shareholders or managers (whichever controlled the company in the particular variant of the PM-ZTC World imagined) not to file the chapter 11 case.¹²³ The bribe would serve the interests of creditors because it would be less than the costs that could be imposed on them through the chapter 11 filing; it would serve the interests of shareholders and managers because it would enable them to walk away with more than they could get by actually filing the chapter 11 case. The existence of chapter 11

120. See *supra* note 1 and accompanying text.

121. Easterbrook has made an interesting use of these properties of the PM-ZTC World. Instead of arguing from rules to the conclusion that they are efficient, he argues that the rules must be efficient or the bargain of the parties would have been to change them. Easterbrook, *supra* note 2, at 411 ("Legal rules endure because they are efficient or because they transfer wealth. Transfers are an implausible explanation of the current bankruptcy regime, leaving efficiency as the prevailing explanation.").

122. As used here and in economic theory, the term *bribe* does not imply that the payment is illegal or improper. It indicates only that one person is paying to acquire the legal entitlements of another or induce the other to use them in a particular way. The payment proposed here would not be illegal or improper. See *infra* note 123.

123. An agreement by the debtor not to file a chapter 11 case would not be legally enforceable against the debtor. See LOPUCKI, *supra* note 44, at 104. But the shareholders could cause the company to surrender its assets to creditors in return for a bribe (cash payment) in an appropriate amount. If bribing management were necessary (because they were assumed to have some independence from shareholders), the propriety of the transaction could be preserved by paying the bribe to shareholders. The shareholders would pay a portion of the money to the managers in the form of severance pay or the purchase of the managers' employment contracts.

Bowers has developed another analysis that reaches the same happy, wealth-maximizing result without the necessity for bribes. He shows that, in the PM-ZTC World, debtors actually will liquidate their own estates prior to bankruptcy, rendering the existence of bankruptcy irrelevant. Bowers, *supra* note 2. In the PM-ZTC World, many other solutions probably exist to the problem of the social cost of bankruptcy.

might or might not make managers and shareholders wealthier at the expense of creditors,¹²⁴ but there is little reason to believe its continuing existence would increase Total (Social) Costs.¹²⁵ In the PM-ZTC World, no one can do anything that does not maximize his own utility,¹²⁶ and with it the utility of society.¹²⁷ An unused chapter 11 is harmless, so its repeal is unnecessary.¹²⁸

As the simplistic nature of this slippery World comes into focus, the limited value of its study becomes clear. That the primary use of the Coase Theorem has been as a tool for economists to study the PM-ZTC World is ironic. Consistent with the view presented here, Coase himself saw his Theorem as a kind of *reductio ad absurdum* of PM-ZTC reasoning — proof that the PM-ZTC World was getting too much attention:

[W]hile consideration of what would happen in a world of zero transaction costs can give us valuable insights, these insights are, in my view, without value except as steps on the way to the analysis of the real world of positive transaction costs. We do not do well to devote ourselves to a detailed study of the world of zero transaction costs, like augurs divining the future by the minute inspection of the entrails of a goose.¹²⁹

Coase's concession that study of the PM-ZTC World can give valuable insights is necessary, but narrow. To put it in perspective, remember that the intense study of fantasy novels can probably also give us valuable insights.¹³⁰

To date, legal scholarship has generally accorded conclusions based on the assumptions of perfect markets or zero transaction costs

124. See Schwab, *supra* note 87, at 1178-83.

125. What reason there is springs from the possibility that a wealthier management class might have different consumption preferences than a wealthier shareholder or creditor class. In the context of the reorganization of large, publicly held companies, these wealth effects would be minimal. See *supra* note 119.

126. See, e.g., Herbert Hovenkamp, *Positivism in Law & Economics*, 78 CAL. L. REV. 815, 828 (1990) ("[W]hat each individual does by definition maximizes his or her utility.").

127. This proposition is inherent in the Coase Theorem. See *supra* note 118 and accompanying text. Not only are the parties to the immediate transaction maximizing utility, so are all other actors in the system.

128. One could counter that, in the PM-ZTC World, repeal of chapter 11 would be effortless. Though there would be no reason to repeal chapter 11, neither would there be reason not to repeal it. Because all actions in the PM-ZTC World are effortless, the issue of what should be done in such circumstances recurs. In making the textual statement, I have implicitly assumed that the concept of inertia should apply even under the twin assumptions of perfect markets and zero transaction costs. Whether my assumption is correct cries out for further analysis, a task I must leave to others.

129. R.H. Coase, *The Coase Theorem and the Empty Core: A Comment*, 24 J.L. & ECON. 183, 187 (1981). The inconsistency between Coase's own views and the uses to which his work has been put is explored in Ellickson, *supra* note 76.

130. For example, many people claim to have gained insights through study of J.R.R. TOLKEIN, *THE HOBBIT* (1937).

a kind of presumptive validity until they can be disproved empirically. The burden has been on the attacker to explain "why the market failed."¹³¹ Drawing PM-ZTC-based conclusions has assumed the mantle of high theory; empirically refuting them has been granted a lower status, insuring that less of it will be done. In the intellectual environment so created, Bradley and Rosenzweig are able to acknowledge explicitly that "[t]he relevance or applicability of the perfect markets solution to the real world depends on the efficiency of the pertinent real-world markets"¹³² and then move directly to the conclusion that the perfect markets solution should be implemented by repealing chapter 11 without having to argue the efficiency of the pertinent real-world markets.¹³³

As yet, no one has demonstrated that any relationship at all exists between the way things work in the PM-ZTC World and the way things work in the world in which we live. No basis exists for assuming that, because a proposition is entirely true in the former world, it is even a little bit true in the latter. To prove that a necessary premise of an argument is false is to defeat the argument. By that standard, all arguments that depend on PM-ZTC assumptions fail, as do all attempts to import conclusions from the PM-ZTC World. The assumptions of perfect markets and zero transaction costs are not "theoretical." They are false. Their falsity renders attempts to set public policy on the basis of conclusions reached in the PM-ZTC World nothing more than arguments by loose analogy.

The PM-ZTC World is just one in a countless number of hypothetical worlds that the human mind can imagine. By pushing the assumptions of that strange world to their limits, Bradley and Rosenzweig have painted a surrealistic landscape in which financial markets guarantee the absence of financial distress and chapter 11 is unnecessary. In their attempt to discredit chapter 11, they have instead discredited the means of economic analysis they employed. Now that we have seen what is possible in the PM-ZTC World, perhaps we are ready to consider that it may have little to teach us. It may be, as

131. Bradley & Rosenzweig explicitly attempt to place the burden, saying that:

In view of the work of these scholars and the theoretical and empirical analyses that we offer, one can question whether there is *any* persuasive theory justifying Chapter 11 insofar as corporate bankruptcies are concerned. It seems to us that, at the very least, proponents of Chapter 11 ought to bear the burden of proving that it does more good than harm.

Bradley & Rosenzweig, *supra* note 4, at 1086 n.102.

132. *Id.* at 1054.

133. In fact, neither market appears to be well developed. See *supra* note 78 (discussing market for public offerings); LoPucki & Whitford, *supra* note 50, at 95-98 & nn. 271-81 (discussing market for distressed companies).

Coase himself suggests, no more than a tautology so elegant that it has mesmerized a generation of legal scholars.