Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results

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Throughout the past two years, Trans World Airlines, Midway Airlines, and R.H. Macy Company,\(^1\) as well as over 46,000 other corporations,\(^2\) have filed petitions for relief under Chapter 11 of the United States Bankruptcy Code.\(^3\) Of the firms that have filed Chapter 11 reorganization petitions, over


\(^{3}\) The Bankruptcy Reform Act of 1978 (Bankruptcy Code), 11 U.S.C. §§ 101-1330 (1988 & Supp. IV 1992). Chapter 11 is the business rehabilitation chapter of the Bankruptcy Code. Id. §§ 1101-1174. A debtor may file a voluntary petition for Chapter 11 pursuant to § 301. Id. § 301. Chapter 11 countenances the rehabilitation of a business entity pursuant to a reorganization plan by which the entity remains in business, albeit with a new ownership structure. In a Chapter 11 reorganization, the assets of the entity are essentially sold to existing participants. That is, a “forced sale” occurs in which creditors and investors sell their claims and receive in return a share of the reorganized company. The shares are distributed according to the absolute priority rule. 11 U.S.C. § 1129 (1988) (providing a set of requirements for plan approval).

In a Chapter 7 liquidation proceeding, by contrast, a firm relinquishes all of its assets to the control of a trustee who sells the assets—either piecemeal or as a functioning unit—to third parties and distributes the proceeds to the firm’s residual claimants. Id. §§ 701-76 (1988 & Supp. IV 1992); see THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 210-11 (1986) [hereinafter JACKSON, LOGIC AND LIMITS] (stating that both reorganization and liquidation are sales of an entity’s assets: reorganization involves a sale to existing claimants and liquidation a sale to third parties); Douglas G. Baird, The
eighty percent will never reorganize successfully and will not avoid a subsequent conversion to a Chapter 7 liquidation proceeding. The effects of these "misfilings" are enormous. Most fundamentally, an attempted reorganization, when liquidation is the more efficient solution, can unnecessarily increase the overall costs of bankruptcy significantly.

In response to these costs, some scholars have called for the repeal of Chapter 11, while others have advocated merely a new approach to Chapter 11 reorganization proceedings. Still others defend the present Chapter 11 system. This Article contends that reducing bankruptcy costs requires a revised Chapter 11 reorganization structure. This Article posits a two-part

Uneasy Case for Corporate Reorganizations, 15 J. LEGAL STUD. 127, 127 n.1 (1986) (arguing a reorganization is a "forced sale" whereby an "investor 'sells' his claim and receives in return a share of the reorganized company"); Robert C. Clark, The Interdisciplinary Study of Legal Evolution, 90 YALE L.J. 1238, 1252-53 (1981) (describing reorganization as the purchase of an insolvent business by its creditors and comparing it with a "true liquidation" under Chapter 7); Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 YALE L.J. 857, 893-96 (1982) (comparing liquidation to reorganization proceedings). The proceeds will be distributed according to the priority of the claim; generally, administrative expenses will be paid first, followed by secured claims. General creditors will then share pro rata. Any remaining proceeds will be distributed to the debtor. 11 U.S.C. § 726 (1988).


A Chapter 11 reorganization proceeding can be converted into a Chapter 7 liquidation proceeding by the debtor, 11 U.S.C. § 1112(a), or pursuant to a request by the United States Trustee or a party in interest upon a showing of cause. Id. § 1112(b).


7 E.g., Warren, supra note 5, at 478.
revision to the present Chapter 11 system: (1) replacing corporate managers acting as debtors in possession with trustees; and (2) establishing a methodology to guide these new decision makers in determining whether a reorganization or a liquidation is the proper course of action in a given case.

In articulating this proposal, Part I of this Article will explore the historical antecedents of the present Chapter 11. Specifically, Part I will survey the common law roots of the corporate insolvency scheme, statutory antecedents to the current Chapter 11, and the legislative history of the current Chapter 11.

Part II explores the role of debtors in possession with a particular emphasis on their three principal types of decisions: Business Activity Decisions, Fundamental Bankruptcy Decisions, and Non-Polar Decisions. Moreover, Part II explores the principal effects of the debtor in possession structure and its accompanying separation of ownership and control. In so doing, this Article will emphasize three particular effects of this separation: (1) the often conflicting duties that debtors in possession face; (2) agency costs; and (3) heightened bankruptcy costs. Part II concludes that heightened bankruptcy costs are primarily the product of managers who act in their own self-interest when making decisions as the debtor in possession.

Part III examines the effectiveness of the Bankruptcy Code's solution to this separation of ownership and control. This critique will include detailed criticisms of the present structure. Part III demonstrates the need for a new solution because the Bankruptcy Code fails to constrain adequately debtor in possession indiscretions with respect to Fundamental Bankruptcy Decisions.

Part IV offers a Proposed Chapter 11, a two-prong solution to reduce bankruptcy costs in Chapter 11 reorganizations. The first prong advocates a bifurcated debtor in possession structure whereby bankruptcy trustees make Fundamental Bankruptcy Decisions and the entity's existing management...
makes Business Activity Decisions. The second prong of the Proposed Chapter 11 countenances the development of a methodology for guiding the trustee in determining whether to proceed with the Chapter 11 reorganization or to convert the proceeding to a Chapter 7 liquidation of the entity. In developing this methodology, the two principal prevailing views of bankruptcy theory will be considered: the economic account and the noneconomic (or value-based) account. After rejecting both these accounts as unsatisfactory, this Article suggests a process-based view that would reduce bankruptcy costs in a manner consistent with the goals of Chapter 11. After discussing potential criticisms and limitations of this model, a brief conclusion will follow.

I. THE DEVELOPMENT OF CHAPTER 11

A. Equity Receiverships

The United States Constitution gives Congress the authority to establish "uniform laws on the subject of Bankruptcies." Congress exercised this authority on a national level for the first time in 1800 with the enactment of a five year interim statute, which was repealed after three years. In 1841, Congress enacted a second bankruptcy statute that survived for only one year. In 1867, a third statute was promulgated, thrice amended, and then repealed in 1878. Finally, Congress adopted the Bankruptcy Act of 1898, which survived, with amendment, until 1978.

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11 See infra part II.A for a discussion of debtor in possession decision making.
13 U.S. CONST. art. 1, § 8. The Framers viewed constitutional authority for the creation of a federal bankruptcy law as essential to the promotion of interstate commerce. See THE FEDERALIST No. 42, at 277-78 (James Madison) (Clinton Rossiter ed., 1961). Notwithstanding the existence of this constitutional provision, the United States Supreme Court in Ogden v. Saunders, 25 U.S. (12 Wheat) 213 (1827), held that the Bankruptcy Clause did not bar state schemes absent preemptive federal legislation.
14 CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 19 (1935) (detailing the history of the first bankruptcy statute, the Bankrupt Act of 1800).
15 Id. at 79-85 (describing the brief history of the Bankrupt Act of August 19, 1841).
16 Id. at 105 (detailing the history of the Bankrupt Act of March 2, 1867). See generally EDWARD I. ALTMAN, CORPORATE BANKRUPTCY IN AMERICA (1971) (discussing the history of bankruptcy law in the United States); PETER J. COLEMAN, DEBTORS AND
In the late nineteenth century, with bankruptcy law unsettled, courts of equity took the initiative and formulated a procedure that is the historical antecedent to the present Chapter 11. Courts of equity responded to the significant problems encountered by railroads prior to 1870. The insolvency of railroads posed grave and unique problems for the American economy and legal system. Railroads possessed enormous assets, rights of way over narrow strips of land, and hundreds or even thousands of miles of iron rails, yet these assets had little scrap value—what else could these assets be used for if not a railroad? In addition, railroads provided vital services to interstate commerce and local communities. Complicating the plight of insolvent railroads was an ineffective legal system; federal legislation was in a constant state of flux and limited state remedies proved inadequate because railroad lines, unlike state jurisdiction, generally extended across several states.

Responding to this problem, courts of equity molded the concept of equity receivership to solve the problem of railroad insolvency. In a traditional receivership, creditors called upon a court of equity to appoint a receiver to take control of a debtor's assets and sell them for the benefit of creditors. Once the court appointed a receiver, the debtor's property was under the control of the receiver and thus was immune from process by another court, including execution by contending claimants. In the typical railroad scen...
rio, a creditor, usually at the prompting of the railroad debtor's lawyers, would petition a court of equity for the appointment of a receiver for the railroad. Most often, the receiver the judge appointed was the old management of the firm who would continue to run the railroad.

While the railroad was in receivership, committees of various groups of creditors would be formed. Subsequently, the committees would meet and agree upon a plan of reorganization, appointing a new reorganization committee to effectuate the plan. All claims would then be turned over to that committee and the reorganization plan would specify the amount that each creditor who surrendered its claim would receive after the reorganization.

Following the formation of the reorganization committee, the receiver would generally orchestrate a foreclosure sale to the reorganization committee, typically the only bidder at the sale. As with any receivership, proceeds of the sale would be distributed to the creditors, in this case, represented by the reorganization committee. The reorganization committee would then form a new corporation, placing the assets it acquired in the foreclosure sale in the new entity. In effect, creditors would give up their claims against the old firm to the reorganization committee, which acquired assets of the new firm with money it borrowed on a short-term basis, paid off creditors of the old firm, and gave these same creditors the stake in the new firm they had been promised in the reorganization plan. This procedure allowed creditors to restructure the debt of a large corporation while permitting the corporation to continue in business as a going concern.

To ensure that all creditors were treated fairly, courts of equity developed the practice of setting an "upset price," relying on a model developed by English courts of chancery. The upset price was a judicially determined minimum price below which the court would not permit the sale of the entity at a foreclosure sale. By ensuring that the upset price was sufficiently high, the court theoretically assured minority creditors that they would receive an amount equivalent to the value of their nonbankruptcy rights.

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25 See BAIRD, supra note 24, at 58.

26 See Investment Registry, Ltd. v. Chicago & M. Elec. R.R., 212 F. 594, 609 (7th Cir. 1913) (suggesting that bidding bondholders can manipulate prices and monopolize foreclosure sales); Duncan v. Mobile & O.R.R., 8 F. Cas. 25, 26 (C.C.S.D. Ala. 1879).

27 See Jervoise v. Clarke, 37 Eng. Rep. 423, 424-25 (Ch. 1820) (ordering Master to sell assets in a public sale as long as the sale price is higher than the price set by the court); 1 EDMUND R. DANIELL, DANIELL'S CHANCERY PRACTICE 946, 949 (8th ed. 1914).

28 See First Nat'l Bank of Cincinnati v. Florsheim, 290 U.S. 504 (1934) (holding that a reorganization plan was a fraudulent conveyance because the price was too low).
CHAPTER 11 REORGANIZATIONS

This solution had limitations. Courts tended to keep the upset price low to ensure that the reorganization committee could finance a purchase of the old entity's assets. This low price, however, compelled creditors to tender their bonds to the reorganization committee even if the plan would give them less than the value of their nonbankruptcy rights, hence undercutting the primary rationale for an upset price.

B. The Bankruptcy Act of 1898

The equity receivership process, formulated to mitigate the consequences of failed railroads, was not a complete success. Recognizing the need for such a process, and yet dissatisfied with judicial attempts at fostering a solution to the unique problem of railroads, Congress took the first step toward enacting reorganization legislation with the Bankruptcy Act of 1898. Although the Bankruptcy Act contained no formal business rehabilitation provision, it displayed "a rather general acceptance of the principle that a bankruptcy law [was] required in the public interest of the nation" and, perhaps more significantly, it legitimized bankruptcy law as a way of resuscitating businesses in the name of the national interest.

In 1938, Congress formalized the goal of business debtor rehabilitation by passing the Chandler Act, which added Chapters X, XI and XII to address business bankruptcies. The Chandler Act's passage indicated Congress's recognition that the prior business rehabilitation provisions were incomplete and also served to "express the national policy that the best interests of the

Because there was no statutory procedure for compelling creditors to participate in a reorganization, any creditor could choose not to assent to the reorganization plan. Creditors who chose not to take part in the reorganization simply had their claims satisfied out of the proceeds of the sale. See Werner, Harris & Buck v. Equitable Trust Co., 35 F.2d 513, 514 (10th Cir. 1929) (holding that a court could not force a creditor to participate in a reorganization); Louis Heft, Holders of Railroad Bonds and Notes: Their Rights and Remedies 117 (1916) (noting that creditors could refuse to participate in reorganization proceedings); James N. Rosenberg, A New Scheme of Reorganization, 17 Col. L. Rev. 523, 528 (1917) (stating that the court lacked authority to compel acceptance of a fair plan). The size of their payment, of course, depended directly upon the price received at the auction.


30 Warren, supra note 14, at 144 (asserting that "the chief interest of the Nation lies in the continuance of a man's business and the conservation of his property for the benefit of creditors and himself, and not in the sale and distribution of his assets among his creditors").

31 Ch. 575, 52 Stat. 883 (1938), repealed by Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549 (enacting Title XI). Section 77B of the Bankruptcy Act, passed in 1934, had already supplanted equity receivership proceedings. That section was the first federal provision governing the reorganization of financially distressed corporations. See 48 Stat. 911 (1934). Section 77B was preceded by § 77A, which governed railroad reorganizations. See 47 Stat. 1467, 1474 (1933).
nation [were] promoted by affording commercial and industrial concerns the protection of bankruptcy law while they under[went] financial and business rehabilitation."

As enacted, Chapter X of the Chandler Act was designed to rehabilitate large corporations having publicly held shares and many strata of public and private debt. To this end, Chapter X contained provisions intended to achieve this result while protecting the interests of secured and unsecured creditors. A Chapter X reorganization plan, for example, could modify the rights of the debtor's equity-holders and could stretch out and scale down claims of secured and unsecured creditors. Additionally, Chapter X required the appointment of a trustee to operate the business in place of management if the amount of the debtor's uncontingent liabilities totaled $250,000 or more. As a practical matter, this meant a trustee was appointed in virtually every Chapter X case. This particular requirement was the product of William O. Douglas, who, while Commissioner of the Securities and Exchange Commission (SEC), chaired an investigation into the treatment of public investors in corporate reorganizations. The investigation generated a study, which sharply criticized what it perceived as abuses against hapless equity-holders by corporate insiders and recognized the potentially undesirable control of management over the reorganization process. The study recommended that a trustee be appointed in every reorganization case. Finally, Chapter X countenanced participation of the SEC in reorganization cases as an advocate for public-security holders, as

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34 See id. (citing Bankruptcy Act § 216(1)).

35 Bankruptcy Act § 156.


37 Gerber noted that the Douglas Study stated:

> [R]eorganizers and investors will at times have different objectives in reorganizations. Investors will be interested in an expeditious, economical, fair, and honest readjustment of their company's affairs. ... Reorganizers at times have not been interested in fair reorganization, since fairness might seriously intrude into their own plans and affairs. Reorganizers at times have not desired honest reorganizations, in the investors' sense of the word, because such reorganizations would be costly to them. They have been motivated by other factors. And they have endeavored—in large measure with success—to mold the reorganization process so as to serve their own objectives.

*Id.* at 299 n.14 (quoting Douglas Study, pt. 1, at 2-5).

38 *Id.* at 300 (citing Douglas Study, pt. 8, at 336-38).
well as an advisor to the court regarding the fairness of the reorganization plan.\(^3\)

Although Chapter X was created for the thoroughgoing reorganization of an entity, typically involving a firm's complete recapitalization, Chapter XI was intended to govern simple reorganizations involving smaller, closely-held businesses. As such, Chapter XI was considerably less elaborate than Chapter X. A Chapter XI plan, for instance, could alter unsecured claims, but not modify the rights of secured creditors or equity-holders.\(^4\) Moreover, whereas in Chapter X cases management was replaced by a court-appointed trustee, in Chapter XI, management remained in possession of a debtor's assets and in control of its affairs unless a receiver was appointed for cause.\(^41\) Finally, the SEC's role in Chapter XI, in which the debtor had an exclusive right to propose a reorganization plan, was considerably less than in Chapter X.\(^42\)

As one might expect, Chapter XI gradually became the rehabilitation vehicle of choice not only for managers of small companies, as intended, but also for managers of large, publicly-held corporations.\(^43\) Specifically, managers preferred Chapter XI because: (1) it minimized the risk that they could be ousted from control and did not subject their actions to scrutiny by an


\(^{40}\) Bankruptcy Act §§ 356-57.

\(^{41}\) Id. § 332. As a practical matter, receivers were rarely appointed in some jurisdictions and quite frequently appointed in others. This allocation of control over the reorganization proceeding was consistent with the Douglas Study's finding that in the context of small businesses, the interests of management and equity-holders would normally be aligned and the appointment of a trustee would prove both costly and superfluous. Gerber noted that the Douglas Study observed:

In ordinary bankruptcy proceedings, concerned with the insolvent individual, the debtor's role is understandably important in the working out of his fortunes, whether these proceedings be directed to liquidation or to composition. Similarly, where the bankrupt is a small corporation with stock closely held by those who have managed the enterprise, the interposition of a corporate entity does not obscure the realities; there is a practical identity between the bankrupt corporation and its stockholders. Management and ownership are substantially one, and the case, at least in these respects, differs little from that of the individual debtor.

The large corporate debtor is far removed from such a state of facts. With stock widely scattered in a multitude of small holdings, and management and stockholders distinct groups, little identity may remain between ownership and control. When such a corporation is in bankruptcy or equity receivership it is irrelevant and confusing to speak of it as the debtor or bankrupt in the same way that these terms are applied to individuals.

Gerber, supra note 33, at 301 n.20 (quoting Douglas Study, pt. 8, at 98).

\(^{42}\) Bankruptcy Act § 306(1).

\(^{43}\) Kevin Delaney, Strategic Bankruptcy: How Corporations and Creditors Use Chapter 11 to Their Advantage 24-25 (1992); David G. Epstein et al., The Law of Bankruptcy 1432 (1992); Gerber, supra note 33, at 302.
independent trustee; (2) it gave the debtor, and therefore management, exclusive right to propose a plan, maximizing management's leverage in plan negotiations; (3) it countenanced a lesser role in the reorganization proceeding for the SEC; and (4) it dealt with unsecured debt only, offering a quicker and cheaper, although less comprehensive, reorganization alternative than Chapter X.\textsuperscript{44}

Litigation often arose on this issue because the Chandler Act was not precise in defining which Chapter a particular business could file under. In the 1940s, 1950s and early 1960s, the SEC often challenged the propriety of Chapter XI filings and attempted to have many cases converted to Chapter X to safeguard what it perceived as the public interest.\textsuperscript{45} By the late 1960s and 1970s, however, the SEC, primarily because of understaffing, stopped challenging Chapter XI filings, and Chapter XI evolved into the rehabilitation vehicle of choice for debtor businesses.\textsuperscript{46}

C. The Bankruptcy Reform Act of 1978

In 1970, Congress created the Commission on the Bankruptcy Laws of the United States (the Commission) and directed it to analyze the Chandler Act and recommend changes in light of financial and commercial developments.\textsuperscript{47} After evaluating the current state of bankruptcy law, the Commission expressed concern that Chapter XI was increasingly used improperly by

\textsuperscript{44} Gerber, supra note 33, at 302; see also Robert J. Rosenberg, Corporate Rehabilitation under the Bankruptcy Act of 1973: Are Reports of the Demise of Chapter XI Greatly Exaggerated?, 53 N.C. L. REV. 1149, 1151-52 (1975) (suggesting that allowing management to retain their jobs in Chapter XI would inevitably make it the preferred alternative to Chapter X).


\textsuperscript{47} See DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 2-7 (1971) (analyzing reasons for Congress's creation of the Commission, including altering bankruptcy law as a response to a substantial increase in number of filings following World War II). Ironically, the notion that revision of the Chandler Act was warranted because of the increasing number of business bankruptcies proved incorrect. In actuality, following the enactment of the Bankruptcy Code, one economic study demonstrated that approximately 19% of business filings between 1978 and 1983 were a direct result of the broadening of bankruptcy law effectuated by the Bankruptcy Code. See Gene A. Marsh & David C. Cheng, The Impact of the Bankruptcy Reform Act on Business Bankruptcy Filings, 36 A.L.A. L. REV. 515, 535 (1985). For an excellent, concise historical background to Chapter 11 see Kenneth W. Klee, The New Bankruptcy Act of 1978, 64 A.B.A. 1865, 1866 (1978); Don J. Miner, Comment, Business Reorganization
large companies. To address this concern, the Commission recommended that Chapters X and XI be merged into a single rehabilitation chapter.\(^4\)

The Commission suggested that under this single chapter a trustee be appointed in any corporate debtor case involving 300 or more security holders and debts of $1,000,000 or more, unless a trustee was found to be "unnecessary" or the expense of such protection was determined to be "disproportionate to the protection afforded."\(^4\)

The SEC both echoed and expanded upon the Commission's findings, asserting that a trustee was essential in all reorganizations so that "investors [could] intelligently decide whether or not proposed plans are fair, equitable, and sound—whether assets are being wasted or overlooked; whether there is a complete accounting for the old venture before the new one is launched; [and] whether the allocation of assets, earnings, and control are fair."\(^5\)

Following the Commission's report, Congress began to enact new bankruptcy legislation. This process proved to be extremely contentious as virtually "every improvement favored by a particular group was strongly opposed by others."\(^6\)

The Senate's version of the bankruptcy bill followed the SEC's recommendation and provided for the mandatory appointment of a trustee in any case involving a public company.\(^6\)

The House's version was considerably different. Believing that the successful rehabilitation of many large companies in Chapter XI indicated that neither the public nor creditors were

\(^4\) The Commission found:

An independent trustee is often desirable, especially in a case involving the reorganization of a corporate debtor having substantial indebtedness and publicly held securities. At the other end of the spectrum is the closely held corporate debtor whose existing management is essential to the continued operation; in such a case an independent trustee is not always needed and is often counterproductive. An arbitrary dividing line, such as the dollar formula of Chapter X of the present act, is undesirable. Indebtedness alone is not an adequate criterion. It does not take into consideration the nature of the ownership of the debtor or a need to continue existing management. This arbitrary approach has been a strong motive behind the expanded utilization of Chapter XI. It also has probably been a factor in delaying the commencement of reorganizations, to the ultimate detriment of security holders


\(^6\) Id. pt. 2, at 261.


\(^5\) S. REP. No. 2266, 95th Cong., 2d Sess. 1104 (1978) ("In the case of a public company, the court, within ten days after the entry of an order for relief under this chapter, shall appoint a disinterested trustee.").
necessarily harmed by allowing the debtor to orchestrate the reorganization, the House concluded that investors and creditors might benefit from the retention of management "because the expense of a trustee is not required and the debtor, who is familiar with his business will be better able to operate it." The House further suggested that a court be permitted to order the appointment of a trustee only if "the protection afforded by a trustee is needed and the costs and expenses of a trustee would not be disproportionately higher than the protection afforded."

After much debate, the Senate and House enacted compromise legislation concerning the role of a trustee in reorganization proceedings. This compromise was embodied in § 1104(a) of the Bankruptcy Code, which provides that the debtor (existing management) will orchestrate the business affairs of an entity as well as its rehabilitation unless, on the motion of a party in interest or the United States trustee, the court orders the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management" or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate." As a practical matter, § 1104(a) means that in typical Chapter 11 reorganization proceedings the existing management of the business entity will orchestrate its reorganization.

II. THE DEBTOR IN POSSESSION STRUCTURE

A. Debtor in Possession Decision Making

The debtor in possession plays the prominent role in a reorganization proceeding. Not only is the debtor in possession often the driving force behind both the negotiation and creation of the reorganization plan, but it also runs the business on a day-to-day basis. In playing these distinct roles, the debtor in possession faces three fundamentally different types of decisions. First, because the debtor in possession controls the day-to-day affairs of the business it must make choices and decisions about the use of existing assets and the daily operations of the business. These decisions can be termed "Business Activity Decisions." Second, the debtor in possession mediates reorganization negotiations, and shapes the tone and character of settlement discussions, thereby influencing the outcome of such discussions. Central to

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54 Id. at 302.
55 See supra note 8.
57 An important subsidiary issue is who actually makes decisions for the debtor in possession: the shareholders, the board of directors, the officers, or the attorneys. Commentators have suggested that the debtor in possession usually is the board of directors and officers. See 6 COLLIER, supra note 21, at 1416; Raymond T. Nimmer & Richard B. Feinberg, Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity, 6 BANKR. DEV. J. 1, 21; see also 11 U.S.C. app. R. 9001 (Supp. IV 1992).
this role is an assessment of the viability and validity of the reorganization proceeding itself. Decisions made in this capacity by the debtor in possession can be referred to as “Fundamental Bankruptcy Decisions.” Finally, the debtor in possession is expected to make decisions and choices that are neither pure business operational decisions nor pure bankruptcy decisions. These “Non-Polar Decisions” involve a balancing and weighing of competing interests and concerns regarding both daily activities and reorganization structure, and by nature they are not subject to characterization as either Business Activity Decisions or Fundamental Bankruptcy Decisions.

1. Business Activity Decisions

Business Activity Decisions concern the use of existing assets as well as everyday business operations. These decisions run the entire spectrum of operating an enterprise; their significance cannot be overstated. These choices not only affect the manner in which the business operates but also the value the business’s assets will produce during liquidation or reorganization.

The quality of Business Activity Decisions affects not only the size of the economic pie available to the various creditors and equity holders, but also the net economic loss caused by the insolvency. Poor decisions will decrease the size of the pie available for distribution; prudent choices may increase the size of the available pie. In addition, Business Activity Decisions may directly affect loss allocation. By reducing the size of the applicable pie, a poor Business Activity Decision may assure that equity holders are given no stake in a reorganized entity, rather than a partial one.

The Bankruptcy Code recognizes that Business Activity Decisions involve matters best decided by persons knowledgeable in business decision making. Therefore, the Bankruptcy Code ordinarily does not provide for judicial review of these decisions. Section 363, for example, grants the trustee, and

58 The debtor in possession, due to self-interest, bias, or mere optimism, may not be the party best situated to make this assessment objectively. See infra part II.B.C.

59 See 11 U.S.C § 1108 (1988) (providing that “[u]nless the court . . . orders otherwise, the trustee may operate the debtor’s business”); In re Simasko Prod. Co., 47 B.R. 444, 449 (D. Colo. 1985) (“Business judgments should be left to the board room and not to this Court.”); In re Deluca Distrib. Co., 38 B.R. 588, 591 (Bankr. N.D. Ohio 1984) (explaining that “[t]he discretion to act with regard to ordinary business matters without prior court approval is at the heart of the trustee’s [the debtor in possession’s] powers”); In re Lifeguard Indus., 37 B.R. 3, 17 (Bankr. S.D. Ohio 1983) (“[B]usiness judgments should be left to the board room and not to this Court.”); Central Sales S.E. & S.W. Areas Health & Welfare & Pension Funds v. Columbia Motor Express, Inc. (In re Columbia Motor Express, Inc.), 33 B.R. 389, 393 (M.D. Tenn. 1983) (“The Bankruptcy Code favors the continued operation of a business by the debtor as debtor-in-possession and a presumption is accorded to the management decisions of the debtor-in-possession.”); In re Curlew Valley Assocs., 14 B.R. 506, 511 (Bankr. D. Utah 1981) (“[D]isagreements over business policy are not amenable to judicial resolution. The judge is not a business consultant. While a court may pass upon the legal effect of a
therefore the debtor in possession,\textsuperscript{60} the general authority to use, sell, or lease property of the estate in the "ordinary course of business" without obtaining prior court approval.\textsuperscript{61} Similarly, § 364 authorizes the debtor in possession to incur unsecured postpetition indebtedness in the "ordinary course of business" unless the "court orders otherwise."\textsuperscript{62} To induce creditors to provide loans to entities in bankruptcy, these loans enjoy administrative expense priority over various other extensions of credit.\textsuperscript{63}

In accordance with the Bankruptcy Code's preference for the debtor in possession being solely responsible for making Business Activity Decisions,\textsuperscript{64} courts customarily leave operation of the business to the debtor in possession's discretion, enforcing choices made by the debtor in possession on operational matters.\textsuperscript{65} In reviewing a debtor in possession's business decisions, courts typically utilize a corporate law concept,\textsuperscript{66} upholding these decisions if they reflect the exercise of rational business judgment.\textsuperscript{67}

business decision . . . this involves a process and the application of criteria fundamentally different from those which produce the decision in the first instance."\textsuperscript{60} Section 1107(a) provides that the debtor in possession has all of the rights, powers and obligations of a trustee under the Bankruptcy Code. See 11 U.S.C. § 1107(a) (1988). Unless the bankruptcy court orders the appointment of a trustee under § 1104(a), the debtor (management) will continue to operate the business as the debtor in possession. Id. § 1104(a).
\textsuperscript{61} Id. § 363(c).
\textsuperscript{62} Id. § 364(a).
\textsuperscript{63} Id. § 503(b)(1).
\textsuperscript{64} See H.R. REP. No. 595, \textit{supra} note 46, at 404; S. REP. No. 989, 95th Cong., 2d Sess. 116 (1978).
\textsuperscript{65} See, e.g., \textit{In re Airlift Int'l, Inc.}, 18 B.R. 787, 789 (Bankr. S.D. Fla. 1982) (stating that policy considerations require that the court not interfere with the trustee's business decisions); Allied Technology, Inc., v. R.B. Brunemann & Sons, 25 B.R. 484, 495 (Bankr. S.D. Ohio 1982) ("Court approval of a debtor in possession's judgement that assumption of a lease is in the best interest of the debtor's business should not be withheld on the basis of [judicial] second guessing . . . .")

Courts review management slackness under the [duty of] care regime, which applies to enterprise ('purely business') decisions untainted by conflicting interests. Filtered by the forgiving presumptions of the business judgment rule, review applies only in egregious cases of deliberate inattention or irrational decision making. In the care regime, plaintiffs must show more than carelessness or unreasonableness. Judicial abstention is the rule.

Id. at 1358-59.
\textsuperscript{67} See Committee of Asbestos-Related Litigants v. Johns-Manville Corp. (\textit{In re Johns-Manville Corp.}), 60 B.R. 612, 615-16 (Bankr. S.D.N.Y. 1986) ("[T]he Code favors the continued operation of a business by a debtor and a presumption of reasonableness attaches to a debtor's management decisions. Where the debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), [we] will generally not entertain objections to the debtor's conduct." (citations omitted)); Richmond Leasing Co. v. Capital Bank, 762 F.2d 1303, 1311 (5th Cir. 1985)
United States Court of Appeals for the Fifth Circuit summarized the reasons for adopting this standard:

[I]n the absence of special circumstances or a specific Code provision, we see no reason to require the debtor to do more than justify its actions under the "business judgment" standard if creditors object. More exacting scrutiny would slow the administration of the debtor's estate and increase its costs, interfere with the Bankruptcy Code's provision for private control of administration of the estate and threaten the court's ability to control the case impartially.68

Utilizing this standard, courts generally have held that the debtor in possession exercised proper business judgment so long as it did not engage in self-dealing, its decision reflected careful investigation and analysis, and the choice made by the debtor in possession bore some reasonable relationship to the proper operation of the enterprise.69

Although the Bankruptcy Code permits debtors in possession to engage in transactions in the ordinary course of business without prior court approval,70 and courts grant debtors in possession broad latitude with

68 Richmond Leasing Co., 762 F.2d at 1311 (citations omitted).
69 See In re Southern Biotech, Inc., 37 B.R. 318, 322-23 (Bankr. M.D. Fla. 1983) ("[T]he court will not entertain objections to the trustee's conduct of the affairs of the estate where the conduct involves a business judgment made in good faith and made on a reasonable basis and within the scope of his authority . . . ."); In re Lyon & Reboli, Inc., 24 B.R. 152, 154 (Bankr. E.D.N.Y. 1982) (noting that reasons for the use of the business judgment standard include: (1) expediting the administration of the estate; (2) promoting the private negotiation process; (3) recognizing that the daily operations of the business do not involve legal decisions; and (4) removing the bankruptcy court from administrative duties); Airlift Int'l, 18 B.R. at 789 ("The broad authority to operate the business of the debtor which is given to a trustee by § 1108 indicates Congressional intent to limit court involvement in business decisions by a trustee."); In re Curlew Valley Assocs., 14 B.R. 306, 309-14 (1981) (discussing statutory and policy reasons for discouraging court supervision of the trustee); H.R. Rep. No. 595, supra note 46, at 89-91, 95-99, 107-09; H.R. Doc. No. 137, supra note 48, pt. 1, at 92-93, 348-349 ("Neither referees nor district judges can adequately police reorganizations. To the extent that they attempt to do so, they create an appearance of bias. The assurance of the impartiality of the judge is also enhanced by having the administrator decide whether the business should be operated and the extent of any operation by the debtor.").
70 Courts typically employ a two-part test to determine whether a transaction is entered into in the ordinary course of business. First, courts ask whether the applicable transaction is consistent with the prior practice of the debtor. See, e.g., Johns-Manville, 60 B.R. at 616 ("The vertical dimension or creditor's expectation test examines the debtor's transaction from the vantage point of a hypothetical creditor and inquires whether the transaction subjects a creditor to economic risks of a nature different from those he accepted when he decided to extend credit."). Second, courts inquire into whether the transaction at issue is ordinary in the debtor's industry. See, e.g., id. at 618
respect to those decisions that they do review, the Bankruptcy Code requires that if a transaction falls outside the ordinary course of business, it can only be concluded with the approval of the bankruptcy court. Section 363(b)(1), for instance, provides that a debtor in possession can only use, sell, or lease estate property outside the ordinary course of business after there has been a "notice and a hearing" before the court.\(^7\) Section 364(b)-(d), moreover, requires court approval before obtaining postpetition financing outside the ordinary course of business.\(^7\)

In recognition of these Bankruptcy Code requirements, courts have imposed a heightened standard of review when debtor in possession decisions fall outside the ordinary course of business or when a contrary express statutory standard is present. In complex postpetition financing arrangements, particularly those involving cross-collateralization,\(^7\) courts consider a myriad of factors in ruling on the merits of the debtor in possession's decision, including whether the debtor is "unable to obtain alternative financing on acceptable terms," whether the proposed lender will "accede to less preferential terms," and whether the "proposed financing is in the best interests of the general creditor body."\(^7\)

Likewise, although courts review most exec-

\(^7\) 11 U.S.C. § 363(b)(1) (providing that "the trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.").


\(^7\) In re Vanguard Diversified Inc., 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983) (stating that cross-collateralization is a last resort that should only be used when other financing is not available and the proposed financing is in the best interest of the general creditors). But see Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.), 963 F.2d 1490, 1494-95 (11th Cir. 1992) (noting that cross-collateralization is inconsistent with the Bankruptcy Code).
utory contract decisions\textsuperscript{75} pursuant to a business judgment standard,\textsuperscript{76} courts employ a heightened standard of scrutiny when rejection of a contract has a particularly egregious effect on a particular individual,\textsuperscript{77} or when the Bankruptcy Code compels a heightened standard.\textsuperscript{78} Finally, courts have subjected the business discretion of the debtor in possession to more exacting scrutiny when the proposed action resolves the majority of economic issues present in the reorganization proceeding.\textsuperscript{79} Typically, this situation arises when the debtor in possession contemplates a sale of the primary assets of the entity or the creation of new contractual relationships that will dominate the affairs of the postpetition entity.\textsuperscript{80}

\textsuperscript{75} 11 U.S.C. § 365(a) (allowing the debtor in possession generally to assume or reject an executory contract). An executory contract is most commonly defined as a “contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Vern Countryman, *Executory Contracts in Bankruptcy* (pt. 1), 57 Minn. L. Rev. 439, 460 (1973).

\textsuperscript{76} See, e.g., Lubrizol Enter. v. Richmond Metal Finishers Inc., 756 F.2d 1043, 1046 (4th Cir. 1985) (stating that bankrupt's decision “is to be accorded the deference mandated by the sound business judgment rule”); In re Prime Motor Inns, 124 B.R. 378, 381 (Bankr. S.D. Fla. 1991) (recognizing the long standing “traditional business judgment standard applied by the courts to authorize rejection of the executory contract”); Blackstone Potato Chip Co. v. Mr. Pepper, Inc. (In re Blackstone Potato Chip Co.), 109 B.R. 557, 560 (Bankr. D.R.I. 1990) (stating that the business judgment standard is appropriate in determining whether a debtor may reject or accept an executory contract).

\textsuperscript{77} See, e.g., In re Petur U.S.A. Instrument Co., 35 B.R. 561 (Bankr. W.D. Wash. 1983) (although applying the business judgment rule, bankruptcy court would not authorize debtor’s rejection of executory contract when granting of motion would result in destruction of business of the nondebtor party and damages sustained by nondebtor party would be grossly disproportionate to any benefit derived by general creditors); Robertson v. Pierce (In re Chi-Feng Huang), 23 B.R. 798 (Bankr. 9th Cir. 1982). Applying the business judgment rule, the *Chi-Feng Huang* court stated:

[It] is proper for the court to refuse to authorize rejection of a lease or executory contract where the party whose contract is to be rejected would be damaged disproportionately to any benefit to be derived by the general creditors of the estate. . . .

This statement does not sanction rejection of a contract because of a generalized concern that a party whose contract is rejected will be damaged.

\textit{Id.} at 801.

\textsuperscript{78} Section 365(h), for instance, limits the effect of rejection of a lease of real property when the debtor is a landlord, whereas § 1113 limits the rejection of collective bargaining contracts in Chapter 11 cases. 11 U.S.C. §§ 365(h), 1113.

\textsuperscript{79} Nimmer & Feinberg, *supra* note 57, at 15-20; see id. at 15 (“The business discretion of the debtor in possession will also be subject to more intense overview when the proposed business action either expressly or de facto substantially resolves most economic issues present in the reorganization.”).

\textsuperscript{80} See Institutional Creditors of Continental Air Lines v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.), 780 F.2d 1223, 1226 (5th Cir. 1986) (limiting asset sale when a sale constitutes a sub rosa plan of reorganization); Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir.
2. Fundamental Bankruptcy Decisions

Fundamental Bankruptcy Decisions are central to the bankruptcy reorganization. These decisions involve choices about whether to proceed with the reorganization or liquidation of the entity as well as the manner in which the assets and losses of the entity will be allocated in the entity's restructuring. In brief, Fundamental Bankruptcy Decisions require the debtor in possession to decide both whether reorganization or liquidation will maximize the size of the economic pie and what division of that pie is optimal.\footnote{The debtor in possession's decision does not occur in a vacuum; creditors influence such a decision. For instance, a secured creditor may file a § 362(d) motion seeking a lifting of the automatic stay on the grounds that its interest is not “adequate[ly] protect[ed].” 11 U.S.C. § 362(d) (1988). The net effect of the successful resolution of this motion on the creditor's behalf may be to force the debtor into choosing liquidation over reorganization. See infra part IV.B.}

The decision regarding whether to reorganize or liquidate the enterprise is critical because of the inherent costs that accompany each choice. If the debtor in possession elects to reorganize a company that is not economically viable\footnote{That is, its total revenues will not meet or exceed its total costs, even with restructuring. See infra part IV.B.} and should be liquidated, then resources are squandered as the entity attempts to engage unsuccessfully in a restructuring. All the parties in interest will bear these costs to the company, and the overall size of the pie available for distribution will decrease.

Similarly, the debtor in possession faces the difficult task of allocating losses among the various claimants. It serves as an arbitrator in a zero sum game: dollars given to one group in a financial restructuring are lost by another. Deciding who wins and loses the game involves choices between a number of competing interests.

Considering the divergent interests among the competing parties highlights the difficult task faced by the debtor in possession. Consider, for example, the incentives of equity holders in a bankruptcy proceeding. Equity holders have the lowest priority in bankruptcy and hence are unlikely to receive anything in a liquidation. Accordingly, they have a strong incentive to encourage the continuation of the entity's operation despite economic realities. Unsecured general creditors who also have low priority have a similar incentive to choose reorganization over liquidation.\footnote{\citeyear{Jackson1983} (“[T]he debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan \textit{sub rosa} in connection with a sale of assets.”); see also Committee of Equity Sec. Holders \textit{v.} Lionel Corp. (\textit{In re} Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) (requiring a “good business reason” to approve the proposed sale); \textit{In re} Public Serv. Co., 90 B.R. 575, 581 (Bankr. D.N.H. 1988) (applying the \textit{Lionel} standard and denying transfer of assets because no sound business justification to support transfer existed); \textit{In re} Naron \& Wagner, Chartered, 88 B.R. 85 (Bankr. D. Md. 1988) (applying the \textit{Lionel} standard and approving proposed sale of subsidiary owned by debtor).}
By contrast, secured creditors are likely to view the liquidation of the business as a desirable result regardless of whether the reorganized entity has a positive going concern value. Any going concern value will not benefit senior claimants such as secured creditors, whereas they may bear the cost of a failed attempt at reorganization. Thus, debtors in possession will feel pressure exerted by senior claimants to liquidate rather than reorganize the entity and these senior claimants will expect, if reorganization is chosen, concessions in their favor in return for acceding to reorganization.

3. Non-Polar Decisions

One might characterize the final type of decisions faced by the debtor in possession as Non-Polar Decisions. These decisions are neither pure Business Activity Decisions nor Fundamental Bankruptcy Decisions, but rather involve elements attributable to both.

An example of a decision that properly could be characterized as a Non-Polar Decision is the sale of a large corporate subsidiary of an entity in bankruptcy. The sale of such a subsidiary affects not only the use of existing assets but also the assets available for allocation. As such, it can neither be characterized as a pure Business Activity Decision nor a pure Fundamental Bankruptcy Decision but rather as a Non-Polar Decision properly made by the debtor in possession both in consideration of the day-to-day business affairs of the corporation as well as in contemplation of loss allocation among the claimants. As noted above, courts recognizing the nature of these Non-Polar Decisions review debtor in possession decisions outside the ordinary course of business with a heightened standard of review.

84 A corollary to the absolute priority rule is that senior claims may not receive compensation in excess of their prepetition claims. See generally Kenneth N. Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 AM. BANKR. L.J. 133 (1979) (explaining priority of claims in bankruptcy).

85 Importantly, as this Article will develop, infra part IV.B, the debtor in possession perhaps should also be required to take into account the interests of parties affected by the proceeding who are not regarded as traditional claimants in bankruptcy, such as employees. Of course, one might expect that employees would prefer reorganization over liquidation so that they can retain their jobs.

This dichotomy of interests aptly illustrates the battles among parties that exist in a typical Chapter 11 scenario. Not only do the debtor and creditors have diametrically opposed positions in many cases, but creditors may often battle creditors in formulating options regarding liquidation versus reorganization.

86 See supra part II.A.1.
B. The Debtor in Possession Structure: A Separation of Ownership and Control

Over fifty years ago in a preeminent work, Professors Adolf Berle and Gardiner Means questioned the notion of "shareholder primacy" because of the separation of ownership and control present in the corporate form.  

They asserted that shareholders generally were passive owners of the corporation and widely diversified risk bearers who had little incentive or ability to monitor managers' activities in the corporations in which shareholders invested. Corporate managers, by contrast, typically owned little of the stock of the corporation for which they were employed and yet controlled the entity's operations. Because managers had little invested in the firm, their primary goal was often not to maximize shareholder wealth, but rather their own utility.

Furthermore, Berle and Means suggested that the ability of shareholders to elect directors, and thereby control management, was relatively meaningless in the context of large corporations. They asserted that management controlled the proxy machinery and hence the outcome of the election. Management, in short, had become a self-perpetuating oligarchy, which only outside regulation could remedy.

Modern economic theorists view the problems created by a separation of ownership and control differently than Berle and Means. These theorists see the corporation as the central party to a contractual arrangement between managers and owners by which factors of production are combined. As theorists Professors Michael Jensen, William Meckling, and Eugene Fama contend, this interrelationship between managers and owners by necessity involves an agency relationship in which the owners (shareholders) serve as principals, receiving the benefits of the firm's profitability and growth, and management as their agents. In essence, owners bear the risks associated with the enterprise while managers run the corporation, as specialized decision makers, for the benefit of the owners.

The primary benefit of this corporate form is readily apparent. Skilled managers, who might lack capital, are able to run the corporation, and shareholders, who might lack managerial skills, may invest in the firm and realize a return on their investment. This specialization of functions also

87 Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 244 (1932); see also Matheson & Olson, supra note 9, at 1330-33 (discussing the history of corporate governance principles and solutions to the problem of separation of ownership and control).

88 See Berle & Means, supra note 87, at 119-25.

89 See id.

90 Id. at 207-19.

91 Id. at 124.

92 See, e.g., Jensen & Meckling, supra note 9, at 306.

93 See, e.g., id.; Fama & Jensen, supra note 9, at 302.

allows investors to diversify their portfolios, thus reducing risk and making
investment more attractive.95 This agency relationship, however, is not
without cost. Foremost, the agency relationship exposes owners to the risk
that managers will use owners’ funds for management’s benefit, thereby cre-
ating agency costs—the costs to the principal of obtaining faithful and effec-
tive performance by its agent.96 From this perspective, the dilemma of the
separation of ownership and control is not viewed in terms of “shareholder
primacy,” as advocated by Berle and Means, but rather as a question of how
to reduce agency costs incurred by owners in monitoring their agents so as to
prevent fiduciary abuse.

Traditionally, the problem of agency costs has been addressed in a variety
of ways. Corporate law imposes liability on managers for any breach of the
fiduciary duties of loyalty and care that management owes to shareholders.97
Under the duty of care standard, a manager must act in good faith, with the
care an ordinarily prudent person in a similar position under similar circum-
stances would exercise and in a manner he or she reasonably believes to be in
the best interests of the corporation.98 The business judgment rule provides

95 Portfolio theory provides that investors may reduce their risk by investing in many
different companies. See John C. Coffee, Jr., Shareholders Versus Managers: The Strain
divides the risk associated with any security into two components: a firm-specific com-
ponent and a systematic or nondiversifiable component associated with general market con-
ditions); Fama & Jensen, supra note 94, at 329 (“Common stock allows residual risk to be
spread across many residual claimants who individually choose the extent to which they
bear risk and who can diversify across organizations offering such claims.”).

96 See Fama & Jensen, supra note 9, at 304 (defining agency costs as the costs of
structuring, monitoring, and bonding a set of contracts among parties with conflicting
interests); Jensen & Meckling, supra note 9, at 293.

97 See generally ROBERT C. CLARK, CORPORATE LAW 93-141 (1986) (explaining
management’s fiduciary duties).

98 See Palmier, supra note 66, at 1358. Invoking the business judgment rule permits
courts to avoid second-guessing the merits of a business decision provided there is no
evidence of bad faith or self-dealing on the part of management. See Melvin A. Eisen-
berg, The Duty of Care of Corporate Directors and Officers, 51 U. Pitt. L. Rev. 945, 948
(1990) (stating that a corporate director’s duty of care consists of three distinct duties: (1)
the duty to monitor the corporation’s business; (2) the duty to inquire about information
that raises cause for concern; and (3) the duty to exercise care in making decisions, both
procedurally and substantively). See generally DENNIS J. BLOCK ET AL., THE BUSINESS
JUDGMENT RULE—FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS 28
(3d ed. 1989) (explaining the duty of care); WILLIAM E. KNEPPER & DAN A. BAILEY,
LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 2.01, at 37 (4th ed. 1988) (con-
demning personal dealing by officers or directors).
that courts should presume managers have fulfilled the requisite duty of care unless the manager has acted with gross negligence.\textsuperscript{99}

To protect against management making self-interested decisions, the duty of loyalty requires managers to make decisions that are in the best interests of the corporation.\textsuperscript{100} In essence, this duty prohibits management from self-dealing and acting faithlessly to the corporation.\textsuperscript{101} To ensure compliance with this duty, courts employ a strict standard of review for management decisions involving a direct conflict of interest.\textsuperscript{102}

Beyond these fiduciary duties, other forces act to constrain managerial indiscretion, including market forces and contractual arrangements between managers and the firm. Contractual relationships can reduce agency costs by providing shareholders with the ability to displace management, such as through the periodic election of the board of directors,\textsuperscript{103} as well as a means by which management’s interests can be aligned with that of the firm, by such incentives as performance-based compensation or stock options.\textsuperscript{104} Market forces, such as the labor market,\textsuperscript{105} production markets,\textsuperscript{106} and market for corporate control,\textsuperscript{107} also may constrain managerial abuses. As proponents of the market-monitoring theory posit, corporations offering

\textsuperscript{99} E.g., Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1983) (stating that Delaware cases impose a less exacting standard than simple negligence).

\textsuperscript{100} See Kenneth E. Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 STAN. L. REV. 927, 937-40 (1983).

\textsuperscript{101} BLA\textsuperscript{E} ET AL., supra note 98, at 73.

\textsuperscript{102} Palmiter, \textit{supra} note 66, at 1364-65.

\textsuperscript{103} See, e.g., DEL. GEN. CORP. LAW § 221 (1991) (stating that the certificate of incorporation may provide shareholders and creditors with the power to vote on displacing management).

\textsuperscript{104} Jensen & Meckling, \textit{supra} note 9, at 323-38; Martin Lipton & Steven A. Rosenblum, \textit{A New System of Corporate Governance: The Quinquennial Election of Directors}, 58 U. CHI. L. REV. 187, 196-97 (1991); see also Fama, \textit{supra} note 94, at 293 (disputing the notion that fractional ownership by managers will itself reduce agency costs).

\textsuperscript{105} Frank H. Easterbrook & Daniel R. Fischel, \textit{Corporate Control Transactions}, 91 YALE L.J. 698, 701 (1982) (stating that management is constrained by salary, bonuses and reputation); Fama, \textit{supra} note 94, at 288 (suggesting that the desire for positive evaluation of ability and such evaluation’s affect on current employment and on the marketability for alternate and future employment will restrain managers from acting inconsistent with the interests of corporate owners).

\textsuperscript{106} Easterbrook & Fischel, \textit{supra} note 105, at 701 (stating that fierce product competition demands a diligently and efficiently managed firm).

shareholders the highest returns will garner the largest investments and hence prosper relative to other entities.\textsuperscript{108}

The separation of ownership and control, widely discussed in the context of solvent corporations, also is present in insolvent corporations\textsuperscript{109} because of the debtor in possession structure. In an insolvent corporation the creditors constitute a new group of owners, which management, acting as the debtor in possession, should serve as their agent.\textsuperscript{110} This separation of ownership and control has three principal effects: (1) it alters the parties to whom management (now the debtor in possession) owes a fiduciary duty; (2) it imposes agency costs; and (3) it increases the overall costs of the given bankruptcy proceeding by increasing the likelihood of improper Fundamental Bankruptcy Decisions.

C. Principal Effects of the Debtor in Possession Structure

1. Fiduciary Duties

In the context of solvent corporations, managers owe fiduciary duties of care and loyalty to the equity holders.\textsuperscript{111} In contrast, if the business becomes insolvent the managers (now the debtors in possession) will have an expanded responsibility to all parties that comprise the estate,\textsuperscript{112} including its creditors.\textsuperscript{113} To fulfill this duty, the debtor in possession will have to


\textsuperscript{109} For purposes of this Article, an entity is "solvent" when the value of its assets exceed its liabilities and "insolvent" when its liabilities exceed the value of its assets. See 11 U.S.C. § 101(32) (Supp. IV 1992).

\textsuperscript{110} In the solvent corporation scenario, equity holders are the residual claimants and thus are best positioned to monitor management to ensure it maximizes the corporation's value. By contrast, once a corporation is insolvent, creditors have the most direct financial interest in reorganization decisions and hence are expected to monitor the debtor in possession.

\textsuperscript{111} See supra notes 97-102 and accompanying text.


Some take issue with the notion that managers are obligated to consider the interests of creditors when a firm becomes insolvent. See BAIRD, supra note 24, at 208 (arguing that because in a Chapter 11 proceeding, creditors are given their own representative through the creditors' committee and equity holders do not have such representation a shifting of duties is not consistent with Chapter 11).

\textsuperscript{113} See In re Central Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987) (stating that the debtor in possession has a duty to maximize the value of estate); Manville Corp. v. Equity
make decisions that will benefit some claimants at the expense of others. Pursuant to this role of loss allocator, the debtor in possession has the power to: propose reorganization plans differentiating among classes of creditors, reject or assume executory contracts, object to claims, and decide whether to seek avoidance of some preexisting transfers and obligations.

Although the debtor in possession has some limitations on its power, its task is both open-ended and extremely difficult; it must attempt to maximize the size of the estate's pie while equitably allocating the pie among the various parties. Maximization and allocation of the estate's assets can be especially difficult because various parties may have differing economic incentives in bankruptcy. For example, fully secured creditors may desire an immediate liquidation of the entity. They have little to gain if the firm continues and much to lose if it ultimately fails to reorganize while depleting the value of secured assets. Unsecured creditors and equity holders, by contrast, may have an incentive to delay liquidation while increasing enterprise risk in the hope of receiving an increased share of the reorganized entity.

Consider, for example, a firm with total assets available for distribution today valued at ten million dollars and outstanding liabilities valued at nineteen million dollars. If the firm is liquidated today, assume the secured creditors will be paid in full—a total of nine million dollars. By contrast, assume that unsecured creditors receive a mere ten percent of their entire claims and equity holders receive nothing.

In turn, posit a situation where the firm is reorganized and continues in business for two years before its ultimate liquidation. Assume now that under this scenario the firm's assets are still valued at ten million dollars, and the firm owes nineteen million dollars, but the value of the secured collateral is only four million five hundred thousand dollars. Here, the secured creditors' secured claim is only one-half of the value in the above scenario, with the remainder becoming an unsecured claim. Correspondingly,


115 See id. § 365(a).

116 See id. § 1106(a).


118 For example, some executory contracts cannot be rejected, others cannot be assumed, and still others can be rejected only on proof of a clear burden to the estate. See id. §§ 365, 1113. Likewise, in proposing a reorganization plan, the debtor in possession must consider the requirements of the absolute priority rule. See 11 U.S.C. § 1129 (1988) (providing a set of requirements for court approval of a reorganization plan).

119 This section is intended to show how the interests of the various parties are diverse. To alleviate this problem, the Bankruptcy Code provides “adequate protection” to a
unsecured creditors, including the claims of the undersecured secured creditors are left to share in a five million five hundred thousand dollar pool, not, as above, in a one million dollar pool. While an immediate liquidation of the corporation satisfied a mere ten percent of the total claims of the unsecured creditors, a liquidation after an attempted reorganization satisfied over thirty-seven percent of the total unsecured
claims. Choosing among the conflicting interests of the various claimants while attempting to maximize the value of the estate pursuant to its fiduciary duties is an arduous task facing the debtor in possession.

2. Agency Costs

As noted above, the separation of ownership and control produces agency costs. Insolvent corporations present this phenomenon because the debtor in possession controls the process of reorganization and loss allocation, even though the residual claimants, the creditors, and equity holders own the corporation.

Significantly, the unique environment of Chapter 11 reorganization proceedings can create an even greater potential for increased agency costs than usually occur in the context of solvent corporations. A predominant reason for these increased costs is that creditors and equity holders face a higher cost of monitoring managers in bankruptcy because the information available for public consumption often is reduced. This reduction in avail-

secured creditor. 11 U.S.C. § 361. However, because a secured creditor must wait for satisfaction of its claim even in a best case reorganization, a secured creditor would likely prefer a liquidation.

120 See BAIRD, supra note 24, at 131-32.

121 Under the Bankruptcy Code, the debtor in possession is given significant discretion in many key areas including classification of claims, 11 U.S.C. § 1122 (1988), rejection of executory contracts, id. § 365(a), and use of avoidance powers, 11 U.S.C. § 544 (1988 & Supp. IV 1992); see 11 U.S.C. § 1107(a) (1988) (giving the debtor in possession powers similar to the trustee). Additionally, managers are given the exclusive right during the first 120 days of reorganization to propose a reorganization plan, id. § 1121(b), and in formulating such a plan are expected to make numerous subjective judgments about the valuation of assets and projection of earnings. See In re United States Truck Co., 47 B.R. 932, 941 (E.D. Mich. 1985) (stating that no “mathematical formula” exists for asset valuation), aff’d sub nom. Nat’l Freight Indus. Negotiating Comm. v. United States Truck Co., 800 F.2d 581 (6th Cir. 1986).

122 See MARTIN J. BIENENSTOCK, BANKRUPTCY REORGANIZATION 66 (1987) (“To whatever extent management . . . may be motivated to put its survival ahead of shareholders’ interests, bankruptcy exacerbates . . . that motivation.”); Gerber, supra note 33, at 347 (“[B]ankruptcy is precisely the time when the ills commonly attributed to the separation of corporate ownership from control—managerial unaccountability and selfish-interest—are likely to be most exacerbated.”).

123 See Erica M. Ryland, Bracing for the “Failure Boom”: Should a Revlon Auction Duty Arise in Chapter 11, 90 COLUM. L. REV. 2255, 2258-63 (1990) (discussing agency costs in bankruptcy). Importantly, the debtor in possession must meet certain reporting
able information is attributable to several factors. First, the Bankruptcy Code permits the debtor in possession to formulate and implement an initial reorganization plan without interference from the residual claimants and without having to provide any information to such claimants. Second, the company frequently postpones shareholders' meetings, delists the stock if it is publicly held, and delays SEC reports. Finally, equity holders are less able to monitor managers because the Bankruptcy Code does not require that an equity holders' committee be appointed, leaving the matter wholly to the discretion of the bankruptcy court.

In addition to increased monitoring costs, the residual claimants also

requirements regarding the status of the reorganization. See 11 U.S.C. app. R. 2015 (Supp. IV 1992). As a general proposition, however, the flow of information to creditors and shareholders often decreases with the filing of bankruptcy.

124 The 120 day exclusivity period granted to debtors in possession with respect to plan formulation is often extended to a year or more, see, e.g., In re United Press Int'l, Inc., 60 B.R. 265, 269-70 (Bankr. D. Colo. 1986), and allows the debtor in possession to exert significant agenda influence. See Michael E. Levine & Charles R. Plott, Agenda Influence and Its Implications, 63 VA. L. REV. 561, 564-65 (1977) ("An agenda influences outcomes . . . ."); Nimmer & Feinberg, supra note 57, at 65-66 ("Because Chapter 11 allows the parties to vote only on plans that have been officially proposed, the right of proposal carries with it an ability to influence the terms of the plan.").

125 See In re Texaco, Inc., 81 B.R. 806, 809 (Bankr. S.D.N.Y. 1988) (stating that the debtor's management should be given an opportunity to formulate a reorganization plan "without interference from creditors and other[s]"). Although the Bankruptcy Code provides that creditors and equity holders must be provided with summaries of proposed reorganization plans and appropriate written disclosure statements, see 11 U.S.C. § 1125 (1988), the Bankruptcy Code does not contain disclosure requirements akin to those contained in the Securities Act of 1933 or the Exchange Act of 1934. See 15 U.S.C. §§ 77-78 (1988 & Supp. IV 1992) (as amended).

126 See Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville), 66 B.R. 517, 542 (Bankr. S.D.N.Y 1986) (granting the debtor in possession an injunction prohibiting a shareholder's meeting when the purpose of the meeting was to elect new directors and propose a new plan more favorable to the shareholders); In re Saxon Indus., 39 B.R. 49, 50 (Bankr. S.D.N.Y. 1984) (finding that management refused to schedule shareholder meetings); Lionel Corp. v. Committee of Equity Sec. Holders of the Lionel Corp. (In re Lionel Corp.), 30 B.R. 327, 330 (Bankr. S.D.N.Y. 1983) (discussing "long overdue annual meetings").

127 Delisting usually occurs because share trading volume has fallen below mandatory exchange minimums. See NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 801.00-9.00 (1989). This can reduce the flow of information. For example, if a stock is delisted, it will no longer have to comply with the New York Stock Exchange requirement that companies respond to certain market rumors or disclose material developments in their businesses. See id. §§ 202.03, 202.05; see also Bradley & Rosenzweig, supra note 5, at 1075 tbl. 11 (noting that 16.7% of publicly traded companies that filed for bankruptcy had their stock delisted within two years of filing).

128 SEC reports are often delayed due to the cost of reporting and because companies no longer benefit from incentives granted for timely filings.

experience a heightened collective-action problem. This problem results from the value of the residual claimants' interests being reduced in bankruptcy, while their costs of action remain constant or even increase. Moreover, even if the residual claimants continue to have an incentive to monitor the debtor in possession because of the potential value of a successful reorganization, uncertainty inherent in the bankruptcy process often can serve to diminish this incentive.

Two final factors raise agency costs in bankruptcy by making it difficult and costly to challenge debtor in possession decisions. First, the class voting mechanism for plan approval, requiring the consent of more than one-half of the holders of a given class of debt as well as holders of two-thirds of the principal amount of the requisite class, prevents a creditor from buying up two-thirds of the principal amount of a given class and proposing its own plan if two other holders remain. Second, the requirement that any party proposing a reorganization plan file a disclosure statement is advantageous to the debtor in possession because preparing such a statement is much easier for the debtor in possession given its knowledge of the business.

3. Bankruptcy Costs

The firm's bankruptcy costs are another product of the separation of ownership and control inherent in the debtor in possession structure. Two distinct types of bankruptcy costs exist: indirect costs and direct costs. Direct bankruptcy costs are the transaction costs of the bankruptcy proceeding. Direct bankruptcy costs include the costs of judicial resources as well as legal, accounting, and financial advisory fees. These costs are essentially wealth transfers from one group to another and as a general proposition are quantifiable.

130 See Baird & Jackson, supra note 12, at 106 (noting that the fundamental purpose of bankruptcy law is to solve the collective action problem by "requir[ing] ... investors to act collectively rather than to take individual actions that are not in the interests of the investors as a group").

131 An example of higher costs in bankruptcy is evident in the operation of the automatic stay, which stops any judicial proceeding against the debtor. See 11 U.S.C. § 362 (1988 & Supp. IV 1992). A party in interest, such as a creditor, can seek to lift the automatic stay, but only upon demonstrating cause or showing that the debtor does not have any equity in the property and such property is not necessary to an effective reorganization. 11 U.S.C. § 362(d) (1988).

132 See id. § 1126(c).


134 Bienenstock, supra note 122, at 580.

135 See, e.g., Theodore Eisenberg, Bankruptcy in the Administrative State, 50 LAW & CONTEMP. PROBS. 3, 42 n.177 (1987) (estimating direct costs of bankruptcy); Jerold B.
By contrast, indirect bankruptcy costs can be explained as the "other" costs of bankruptcy. Examples of these "other" costs include the diminution in stock value of an entity that has filed for bankruptcy protection\textsuperscript{136} and the unquantifiable costs occurring when an entity chooses reorganization, although liquidation is the preferable alternative.\textsuperscript{137} These indirect bankruptcy costs are the social costs of bankruptcy. That is, they increase marginal costs of production by increasing, for example, the costs that credit lenders charge because they believe debtors will prefer Chapter 11 over Chapter 7, even though Chapter 7 may be the better economic alternative. Although difficult to quantify, these indirect bankruptcy costs can be substantial, as illustrated by the Texaco-Penzoil legal battle regarding Getty Oil when Texaco, seeking to avoid liability arising from a devastatingly unfavorable jury verdict, declared bankruptcy and suffered a diminution in stock value of over four billion dollars.\textsuperscript{138}

The debtor in possession structure and its requisite separation of ownership and control primarily is responsible for these sizeable indirect bankruptcy costs. Current bankruptcy law places the debtor in possession in the role of making both Business Activity Decisions and Fundamental Bankruptcy Decisions. In making these decisions, the debtor in possession will make decisions favorable to it, whether or not such decisions are favorable to the new residual owners of the corporation, the creditors. Most importantly, with respect to Fundamental Bankruptcy Decisions, one can expect debtors

\textsuperscript{136} Clearly, the prospect and actual filing of bankruptcy, and the accompanying negative stigma associated with bankruptcy, will diminish the stock value of a corporate entity. \textit{See}, \textit{e.g.}, Bradley & Rosenzweig, supra note 5, at 1067-69; David M. Cutler & Lawrence H. Summers, \textit{The Cost of Conflict Resolution and Financial Distress: Evidence from the Texaco-Penzoil Litigation}, 19 RAND J. ECON. 157, 159-64 (1988). Notwithstanding this decrease in stock value, however, Chapter 11, rather than the gasp of a troubled company, has become an alternative that managers often embrace irrespective of a corporation's solvency. \textit{See} \textit{Delaney}, supra note 43, at 160-90. \textit{But see} Susan Rose-Ackerman, \textit{Risk Taking and Ruin: Bankruptcy and Investment Choice}, 20 J. LEGAL STUD. 277, 279 (1991) (arguing that most managers seek to avoid bankruptcy). Moreover, an active market exists for the shares of bankrupt companies as evidenced by the number of mutual funds that purchase the shares of such entities including: Merrill Lynch Phoenix A, Third Avenue Fund, Fidelity Capital & Income, and Mutual Beacon.

\textsuperscript{137} As this Article will develop, liquidation is the preferred alternative if the liquidation value of a given entity exceeds its reorganization value. \textit{See infra} part IV.B.2.

\textsuperscript{138} Cutler & Summers, supra note 136, at 160. One study placed the combined direct and indirect costs to an entity of bankruptcy at a range from 11-17% of the firm's value within three years of bankruptcy. Edward I. Altman, \textit{A Further Empirical Investigation of the Bankruptcy Cost Question}, 39 J. FIN. 1067, 1087 (1984).
in possession to favor reorganization over liquidation even when the pre-
ferred choice for the entity and the residual owners is liquidation.

Debtors in possession will likely favor reorganization for two reasons. 
First, debtors in possession (management) may have an equity stake in the 
corporation, especially in the context of small corporations in which manage-
ners often are the principal owners. This equity interest will induce the 
debtor in possession to make decisions that benefit equity holders at the 
expense of other claimants, including creditors. Because equity holders gen-
erally receive very little in a liquidation, one would expect that they would 
prefer, and attempt to engage in, a reorganization, despite its effects on the 
other claimants. Although preferring reorganizations over liquidations, per-
ceived wealth maximization in Chapter 11 relative to Chapter 7 may influ-
ence the debtor in possession.

A mathematical model illustrates the effects of the alignment of manage-
rial and equity interests in bankruptcy. A debtor in possession contemplating 
bankruptcy faces two alternatives: liquidation or reorganization. Assume the liquidation value of the firm’s assets is $L$ and the transaction 
costs of liquidation are $T_L$. The expected present value of future earnings of 
the firm in reorganization is $R$. Suppose, moreover, the transaction costs of 
reorganization are $T_R$.

The debtor in possession, with an equity stake in the firm, can be expected 
to choose between the two alternatives according to which alternative maxi-
mizes the value of equity.

139 Of course, managers of large companies also often own shares in the entity, 
although usually their ownership interest is relatively small. Cf. Lynn M. LoPucki & 
William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, 
may not align with shareholders).

140 See Allan C. Eberhart et al., Security Pricing and Deviations from the Absolute 
Priority Rule in Bankruptcy Proceedings, 45 J. Fin. 1457, 1458 (1990) (noting that 
amounts paid to shareholders of bankrupt companies in excess of appropriate amounts 
under the absolute priority rule represent 7.6% of the total amount awarded to all 
claimants).

141 A model derived from the work of Michelle White can explain the debtor’s incentives 
in greater mathematical detail. See Michelle J. White, Bankruptcy Costs and the 
New Bankruptcy Code, 38 J. Fin. 477 (1983). Posit a two period model: The firm has 
unsecured loans due in $t_1 = 1991$ of principal amount $U_1$ and in $t_2 = 1992$ of principal 
amount $U_2$ and secured loans due in $t_2 = 1992$ of $S$. Assume the interest rate and the 
discount rate are zero and that secured loans are riskless. The firm’s earnings in $t_1$ are $P_1$ 
and in $t_2$ are $P_2 + g$, where $g$ is a random variable distributed normally with mean 0 and 
variance $\sigma_g^2$.

The debtor in possession, with an equity stake in the firm, can be expected to choose 
between the two alternatives according to which maximizes the value of equity. The 
value of equity if liquidation occurs in $t_1 = 1991$ is $(L - T_L - S - U_1 - U_2)$, if greater than zero.

Consider now reorganization when the plan is confirmed immediately. In this instance 
the firm’s unsecured liabilities are cut back to $r\%$ of their previous level. Also, the firm
session may have incentives to make economically inefficient decisions and therefore generate indirect bankruptcy costs. From an economic efficiency viewpoint, the best use of the firm’s assets requires choosing the alternative having the highest value between the choices \( L - T_L \) or \( R - T_R \). Thus liquidation is preferred if \( L - T_L > R - T_R \), but the debtor in possession has an incentive to choose liquidation or reorganization depending on which option maximizes the value of equity. If the economically efficient alternative also maximizes the value of equity, then the debtor in possession has an incentive to make economically efficient decisions and indirect bankruptcy costs are nominal.\(^{142}\) However, if an economically inefficient alternative maximizes the value of equity, then the debtor in possession has an incentive to make inefficient decisions, hence generating indirect bankruptcy costs equal to the amount of the efficient alternative less the alternative chosen. Not unexpectedly, unsecured creditors bear the primary costs of debtors in possession aligning their interests with equity without considering the efficient alternative.\(^{143}\)

More significantly, debtors in possession are more likely to favor reorganizations because they are its principal beneficiaries.\(^{144}\) Not only does Chapter 11 provide a corporate debtor with considerable latitude regarding its creditors,\(^{145}\) it also offers managers an opportunity to retain their jobs and orchestrate the reorganization as the debtor in possession.\(^{146}\) This inducement of

\[ f_b \int_0^\infty [P_2 + g - rU_2 - S - S^*] f(g) dg \]

where \( S^* = rU_1 + T_R - P_n \), the amount borrowed in \( t_1 \), if greater than zero. Equity receives nothing in that period. In \( t_2 \) it may receive earnings net of debt payments as cut back under the reorganization plan, if these are positive, or else zero. The minimum level of earnings necessary to avoid liquidation in \( t_2 \) is \( P_2 + g = rU_2 + S + S^* \). The cutoff level of \( g \) is denoted by \( b_0 \).

\(^{142}\) There are, of course, still direct bankruptcy costs.

\(^{143}\) See White, supra note 141, at 479.

\(^{144}\) See Bradley & Rosenzweig, supra note 5, at 1076-77.


\(^{146}\) See Lynn M. LoPucki, The Debtor in Full Control-Systems Failure Under Chapter 11 of the Bankruptcy Code? 57 AM. BANKR. L.J. 247, 265 (1983). Two studies report that on average only 29% of corporate managers and only 46% of incumbent directors remain in office following a corporate reorganization. Stuart C. Gilson, Management Turnover and Financial Distress, 25 J. FIN. ECON. 241, 247 tbl. 3 (1989); Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders, 27 J. FIN. ECON. 355, 386 (1990). The obvious retort to these studies, even accepting their findings, is that for managers and
continued employment, intended by Congress, is particularly appealing to management given both their past investments of human capital in the firm and their probable reluctance to associate with a failed entity.

III. Bankruptcy Code Solutions to the Debtor in Possession Dilemma

The Bankruptcy Code offers four principal solutions to the dilemma created by the separation of ownership and control inherent in the debtor in possession structure: (1) it provides that the debtor in possession has a fiduciary duty to act in the best interests of the entity's claimants; (2) it creates creditors' committees and allows for the creation of equity holders' committees to influence debtor in possession decision making; (3) it permits claimants to propose reorganization plans distinct from that offered by the debtor in possession; and (4) it provides for the removal of the debtor in possession in certain circumstances. The legal and practical limitations placed on these provisions, however, make them ineffective in curbing debtor in possession abuses.

A. Fiduciary Duties of the Debtor in Possession

As noted previously, the Bankruptcy Code imposes a fiduciary duty upon all the claimants of the estate:

[I]f a debtor remains in possession—that is, if a trustee is not appointed—the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor. . . . Indeed, the willingness of courts to leave debtors in possession "is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee." This expanded fiduciary duty of the trustee (the debtor in possession), not only to consider the interests of equity holders as in the case of solvent corporations, but also the interests of creditors, stems from the notion that a directors a 30-50% chance of retaining their jobs is better than the prospect that awaits them if the firm is liquidated: unemployment. See LoPucki & Whitford, supra note 139, at 726 (noting that in 72% of the cases studied corporate managers were replaced during the pendency of the Chapter 11 case).

147 See H.R. REP. No. 595, supra note 46, at 232-34.
150 Notably, even outside of bankruptcy, some courts have suggested that if the business becomes insolvent then the fiduciary obligations of the directors expand to include the interests of creditors. See, e.g., FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982) (commenting that "[w]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors"), cert. denied, 461 U.S. 928
corporate entity should be operated to respond to the interests of those who hold an immediate financial stake in the entity. In the solvent corporation, the shareholders hold such a stake. In an insolvent corporation, however, because the firm's assets are inadequate to pay off all of its debts, the claims of the creditors take on a significance akin to those of the shareholders.

Although the debtor in possession structure, in theory, seems a plausible solution to the problem of the separation of ownership, in practice the expansion of fiduciary duty principles to embrace all claimants fails to align adequately the interests of debtors in possession with other claimants. Most problematically, because loss allocation involves a zero sum game, the various interests of equity holders and creditors frequently will conflict. A debtor in possession decision benefitting one group may harm another. This dichotomy of interests greatly complicates fulfillment of the debtor in possession's fiduciary duties to the entire estate.

Additionally, while the debtor in possession may owe fiduciary duties of care and loyalty to all claimants of the estate, debtor in possession actions seldom are subject to judicial review and only rarely overturned. Applying the business judgment test employed in the context of solvent corporations, courts have granted debtors in possession broad "discretion to exercise reasonable judgment," overruling the debtor in possession's decision only where there is evidence of "fraud, bad faith, gross overreaching or abuse of discretion." In a few limited instances, courts have employed a


See Nimmer & Feinberg, supra note 57, at 31-32.

Id.


See, e.g., Treadway Co. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) (applying the business judgment rule to incumbent management's decision concerning whether to issue and sell stock); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980) (finding that the business judgment rule "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of" the corporation).

See Armstrong World Indus., Inc. v. Phillips (In re James A. Phillips, Inc.), 29 B.R. 381, 394 (Bankr. S.D.N.Y. 1983) (noting that so long as the action taken by the debtor fits within the reasonable expectations of the creditors, the action will not be subject to review by the court); Allied Technology, Inc., v. R.B. Brunneman & Sons, Inc. (In re Allied Technology, Inc.), 25 B.R. 484, 495 (Bankr. S.D. Ohio 1982).

See Treadway, 638 F.2d at 382 (noting that absent evidence of self-dealing, bad faith, or fraud, the business judgment rule presumes that directors act in good faith and therefore need not account for their actions); Crouse-Hinds, 634 F.2d at 702.
higher standard of review. Specifically, courts have used a higher standard of scrutiny when investigating purported violations of the duty of loyalty, when a decision imposes a large adverse impact on a particular party, or where the character of a decision is such that it essentially dominates the outcome of the entire case. In these rare instances, courts have required the debtor in possession to present "a good business reason" to justify its actions. Generally, however, courts have granted debtors in possession broad discretion in fulfilling their fiduciary duties.

The consequences of this standard of review are readily evident. Because a court is unlikely to overturn debtor in possession decisions, fiduciary duties imposed on debtors in possession do little to curb their indiscretions. Thus, without any practical bite, the debtor in possession's current fiduciary duties are an inadequate solution to the dilemma posed by the separation of ownership and control in the debtor in possession structure.

B. Creditors' and Equity Holders' Committees

The Bankruptcy Code also attempts to curb debtor in possession indiscretions through the utilization of a committee structure. Under the Bankruptcy Code, a debtor in possession can both utilize assets in the ordinary course, as well as propose a reorganization plan. In each instance, however, these debtor in possession powers are subject to a secured creditor's right to protect its security interest and to insist on receiving no less than the value of its collateral.

Although the Bankruptcy Code does not provide unsecured creditors or equity holders with rights in specific property, it does provide any "party in

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157 See, e.g., Pepper v. Litton, 308 U.S. 295, 306 (1939) (subjecting director's dealings with the corporation to rigorous scrutiny and placing the burden on the director "to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation").

158 See, e.g., Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 440 (1968) (reversing the lower court's approval of a plan of reorganization because excluding shareholders left a question of whether the plan was fair and equitable under the Bankruptcy Act); In re Petur U.S.A. Instrument Co., 35 B.R. 561, 563 (Bankr. W.D. Wash. 1983) (refusing to authorize the debtor's rejection of an executory contract when such rejection would destroy a profitable business).

159 See, e.g., Committee of Equity Security Holders v. Lionel Corp. (In re Lionel), 722 F.2d 1063 (2d Cir. 1983) (holding that a judge must determine that there is a good business reason to sell an important asset outside the ordinary course of business); In re Public Serv. Co., 90 B.R. 575, 581 (Bankr. D.N.H. 1988) (applying a higher standard of review than the business judgment rule for transactions not in the ordinary course of business); see also Nimmer & Feinberg, supra note 57, at 14-20.

160 In re Lionel, 722 F.2d at 1071; accord In re Public Serv. Co., 90 B.R. at 581.


162 See id. §§ 1121(a)-(b).

163 See id. § 362(d).

164 See id. § 1129(b).
interest” with the ability to raise and be heard on any issue in the case.\footnote{165} Chapter 11 specifically requires that a United States Trustee appoint a committee of creditors holding unsecured claims as soon as practicable in every case.\footnote{166} Moreover, Chapter 11 grants the bankruptcy court authority to order the appointment of additional creditors’ committees and an equity security holders’ committee, if such committees are necessary to “assure adequate representation of creditors or equity security holders.”\footnote{167}

Under the Bankruptcy Code, the creditors’ committee is composed of those creditors willing to serve who hold the seven largest unsecured claims against the debtor.\footnote{168} The responsibilities of the committee are multi-fold: (1) to consult with the debtor in possession regarding case administration;\footnote{169} (2) to investigate the condition and conduct of the debtor;\footnote{170} (3) to participate in plan formulation;\footnote{171} and (4) to perform other services that are in the interest of those represented.\footnote{172} In theory, committees should have significant influence over the outcome of the reorganization proceeding, hence curbing debtor in possession indiscretions. In practice, however, they rarely exert such influence.

Several factors explain this failure. First, although the Bankruptcy Code provides that the United States Trustee “shall appoint a committee,”\footnote{173} one study has suggested that committees are actually appointed in less than half the Chapter 11 cases.\footnote{174} Even when committees are appointed, they are rarely active.\footnote{175} Second, courts seldom exercise their power to appoint addi-

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\footnote{165} The term “party in interest” includes “the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or an indenture trustee.” Id. § 1109(b).

\footnote{166} See id. § 1102(a).

\footnote{167} See id. § 1102(a); see, e.g., Committee of Asbestos-Related Litigants v. Johns-Manville Corp. (In re Johns-Manville Corp.), 32 B.R. 728, 730 (Bankr. S.D.N.Y. 1983).

\footnote{168} 11 U.S.C. § 1102(b)(1). In practice, the creditors’ committee often involves a distinctly different group of creditors.

\footnote{169} Id. § 1103(c)(1).

\footnote{170} Id. § 1103(c)(2).

\footnote{171} Id. § 1103(c)(3).

\footnote{172} Id. § 1103(c)(5); see In re George Worthington Co., 921 F.2d 626, 633 (9th Cir. 1990) (citing In re GHR Energy Corp., 35 B.R. 539, 543 (Bankr. D. Mass. 1983)).


\footnote{174} LoPucki, supra note 146, at 250 (stating that creditors’ committees are appointed in only 40% of cases studied). But see LoPucki & Whitford, supra note 139, at 681 (noting that in large corporate bankruptcies—those involving corporations with over $100 million in assets—a committee was appointed in all but one instance).

\footnote{175} Jerome R. Kerkman, The Debtor in Full Control: A Case for Adoption of the Trustee System, 70 MARQ. L. REV. 159, 183 (1987) (claiming that creditors’ committees are active in only 16-38% of cases studied); LoPucki, supra note 146, at 250-51 (stating that in cases studied only 47% of creditors’ committees appointed counsel, only 11% of creditors’ committees employed accountants, and none proposed a reorganization plan or filed an objection to proposed plans); cf. LoPucki & Whitford, supra note 139, at 681.
tional creditors' or equity holders' committees. Usually, courts only create
additional creditors' committees when there is an intense level of conflict in
the committee structure.\textsuperscript{176} Third, courts typically only authorize the cre-
ation of an equity holders' committee where: (1) the number of shareholders
is large; (2) the case is exceedingly complex; and (3) the benefits of the com-
mittee outweigh its costs.\textsuperscript{177}

Several other elements contribute to the ineffectiveness of committees.
The lack of compensation beyond expenses\textsuperscript{178} provided to committee mem-
bers is problematic because it creates a disincentive for spending considera-
tible time on committee matters. Moreover, the committee members rarely
have the expertise required for them to conduct their expected duties. Few
have experience with reorganization proceedings and still fewer are equipped
with the skills required to evaluate and investigate a debtor's business or
reorganization plan.\textsuperscript{179} In short, individual creditors or equity holders rarely
will exercise this diffuse right to be heard because of the prohibitive costs
involved.\textsuperscript{180} Finally, and perhaps most significantly, the effectiveness of
these committees is limited by their inability to control directly the debtor in
possession. They can only influence debtor in possession actions, not compel
them.

(finding that in 43 cases studied, only 20 involved appointment of additional creditors' committees).

\textsuperscript{176} See, e.g., \textit{In re} Texaco, Inc., 79 B.R. 560, 567 (Bankr. S.D.N.Y. 1987) (stating that
"[a] separate committee of unsecured industry creditors should not exist mainly as a vehicle to [keep Penzoil off the General Creditor's Committee]"); \textit{In re} Baldwin-United Corp., 45 B.R. 375, 376 (Bankr. S.D. Ohio 1983) (declining to appoint additional credit-
ors' committee solely due to a conflict among the creditors in a committee).

\textsuperscript{177} See, e.g., Alberto v. Johns-Manville Corp. (\textit{In re} Johns-Manville Corp.), 68 B.R.
155, 159-60 (S.D.N.Y. 1986); \textit{In re} Mansfield Ferrous Castings, Inc., 96 B.R. 779, 781
(Bankr. N.D. Ohio 1988) (declining to appoint an official committee of equity holders
because existing unofficial committee adequately represented shareholders' interests);
Manville Corp. v. Equity Security Holders Comm. (\textit{In re} Johns-Manville Corp.), 52 B.R.

1991) (holding that members of creditors' committee were entitled to reimbursement for expenses); \textit{In re} Northeast Dairy Coop. Fed'n, 76 B.R. 914, 916 (Bankr. N.D.N.Y. 1987)
(same); \textit{In re} GHR Energy Corp., 35 B.R. 539, 543 (Bankr. D. Mass. 1983) (same); \textit{In re}
Automotive Nat'l Brands, Inc., 65 B.R. 412, 414 (Bankr. W.D. Pa. 1986) (holding that the creditors' committee will not be reimbursed for expenses); \textit{In re} Interstate

\textsuperscript{179} See LoPucki, \textit{supra} note 146, at 251-53.

\textsuperscript{180} For example, if unsecured claims are likely to receive a mere 10 cents on the dollar,
it is unlikely that holders of these claims will have an incentive to challenge debtor in
possession decision making.
C. Reorganization Plans

The third prominent limitation imposed on debtor in possession decision making by the Bankruptcy Code is the ability of "any party in interest, including . . . a creditors' committee" to propose a plan of reorganization.\textsuperscript{181} As commentators have noted, "this reservoir of power should make the debtor more sensitive to the desire of creditors with respect to the actual plan of reorganization."\textsuperscript{182} In brief, it offers other parties a direct opportunity to shape the entity's restructuring as well as loss allocation.

Unfortunately, a number of limitations on this right restrict the ability of committees to address debtor in possession abuses. Foremost, the Bankruptcy Code provides that the debtor in possession has an exclusive right to file a reorganization plan during the first 120 days of the case.\textsuperscript{183} Moreover, upon request of a party in interest, this exclusive period may be extended "for cause."\textsuperscript{184} The Bankruptcy Code does not define "cause," leaving the meaning of the phrase to be gleaned from the facts and circumstances of each individual case,\textsuperscript{185} and allowing courts to extend the 120 day period at the debtor in possession's request.\textsuperscript{186}

The exclusive right to propose a plan carries with it the ability to present an agenda. This important ability, in turn, allows the debtor in possession to influence the outcome of the plan. For example, in formulating a plan the debtor in possession has some latitude in defining how creditors are classified for purposes of payment and voting. By manipulating these classifications, the debtor in possession can enhance the probability of confirmation of a plan that it views favorably.\textsuperscript{187}

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\textsuperscript{183} 11 U.S.C. § 1121(b).
\textsuperscript{184} Id. § 1121(d).
\textsuperscript{185} See In re Public Serv. Co., 88 B.R. 521, 533-34 (1988) (citing 5 COllIER ON BANKRUPTCY ¶ 1121.04, at 1121-14 to 1121-17 (Lawrence P. King ed., 15th ed. 1979)).
\textsuperscript{186} E.g., Gaines v. Perkins (In re Perkins), 71 B.R. 294, 297 (W.D. Tenn. 1987) (granting extension based on statutory language, congressional intent, and logic); In re United Press Int'l, 60 B.R. 265, 269 (Bankr. D.C. 1986) (finding that the debtor in a major, complex case was "extraordinarily" diligent and displayed both speed and skill in the face of major obstacles, thereby warranting an extension of the period of exclusivity); In re Manville Forest Prod. Corp., 31 B.R. 991, 994-95 (S.D.N.Y. 1983) (granting debtor's request for an extension because of sheer mass, weight, volume, and complexity of case), aff'd sub nom. Florida Partners Corp. v. Southeast Co. (In re Southeast Co.), 868 F.2d 335 (9th Cir. 1989); see LoPucki & Whitford, supra note 139, at 693 (noting that bankruptcy judges extended exclusivity period in 34 of 43 cases studied).
\textsuperscript{187} See Teamsters Nat'l Freight Indus. Negotiating Comm. v. United States Truck Co. (In re United States Truck Co.), 800 F.2d 581, 586-87 (6th Cir. 1986) (permitting classifications based on desire to create a consenting class of creditors); Barnes v. Whelan, 689 F.2d 193, 200-02 (D.C. Cir. 1982) (permitting classifications resulting in wide variations in distributions so long as claims placed within the same group are "substantially
Even when the exclusivity period expires, other parties to the reorganization proceeding seldom file reorganization plans. Two considerations may shed light on this phenomenon. First, creditors' committees are unlikely to propose a plan that requires the liquidation of the business since they invariably receive little or nothing in a liquidation. Second, parties other than the debtor in possession generally lack both access to reliable information as well as skills necessary to interpret any information they may be able to acquire.

D. Replacement of the Debtor in Possession

The final mechanism the Bankruptcy Code employs to control debtor in possession actions is to allow, in certain circumstances, the debtor in possession's replacement. Section 1104 of the Bankruptcy Code provides that a trustee can be appointed to replace the debtor in possession, and thus operate the business, under two circumstances: (1) "for cause"; or (2) if such appointment is "in the interests of creditors, any equity security holders, and other interests of the estate." Section 1104(a)(1) further defines "cause" to include "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case."

Typically, courts have sanctioned the replacement of the debtor in possession "for cause" if the debtor in possession's decisions constitute gross mismanagement or incompetence, if the debtor in possession engages in self-similar operations, or if the debtor in possession's actions are biased in favor of particular creditors. The court may also replace the debtor in possession "in the interests of creditors, any equity security holders, and other interests of the estate" if the replacement is necessary to protect the interests of those parties.

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188 LoPucki, supra note 146, at 254-57.
189 See supra part III.B.
190 See supra part II.C.2.
192 Id. § 1104(a)(1).
193 See, e.g., In re Mako, Inc., 102 B.R. 809, 812 (Bankr. E.D. Okla. 1988), (citing In
dealing or there are indications of a conflict of interest, if the debtor in possession diverts estate property so that it is no longer available for creditors, either before or after filing, or if the court determines that parties lack confidence in the debtor in possession's abilities. In determining whether the second prong of § 1104(a) is met, courts have "look[ed] to the practical realities and necessities" of the case. In so doing, courts have engaged in a rudimentary form of cost-benefit analysis, asking whether "the benefits derived by the appointment of a trustee [outweigh] the cost[s] of the appointment," or, alternatively, if the "trustee will accomplish the goals of the Chapter 11 plan more efficiently and effectively."


See, e.g., In re Sharon Steel Corp., 871 F.2d 1217, 1126 (3d Cir. 1989) (finding that violative management practices include payments to chief executive officer without consideration); Oklahoma Ref. Co. v. Blaik (In re Oklahoma Ref. Co.), 838 F.2d 1133, 1135 (10th Cir. 1988) (appointing trustee after debtor in possession transferred assets in a way that harmed estate); In re McCorhill Publishing, Inc., 73 B.R. 1013, 1017 (Bankr. S.D.N.Y. 1987) (finding that management had conflicting interests in affiliated companies that engaged in self-serving transactions to the detriment of debtor); In re Colby Constr. Corp., 51 B.R. 113, 116-17 (Bankr. S.D.N.Y. 1985) (find the majority shareholder's use of corporate assets to be self-dealing).

See, e.g., In re Bonded Mailings, Inc., 20 B.R. 781, 784-86 (Bankr. E.D.N.Y. 1982) (finding that management engaged in fraudulent conduct by shifting assets among corporate debtors in an effort to confuse their records); In re Main Line Motors, Inc. 9 B.R. 782, 783 (Bankr. E.D. Pa. 1981) (replacing debtor in possession because its president withdrew funds from the debtor's operations and placed them in control of two non-debtor affiliates).


In re Ionosphere Clubs, 113 B.R. at 168.

Id. at 168; see also In re Microwave Prod. of Am., 102 B.R. 666, 676 (Bankr. W.D. Tenn. 1989) (weighing the costs and benefits of appointing a trustee).

In re Parker Grande Dev., Inc., 64 B.R. 557, 561 (Bankr. S.D. Ind. 1986). Notably, courts have also approved the appointment of trustees in situations outside of those
Besides the appointment of a trustee, equity holders of the corporation can also remove and replace the debtor in possession by electing a new board of directors.\textsuperscript{201} In \textit{Saxon Industries, Inc. v. NKFW Partners (In re Saxon Industries)},\textsuperscript{202} for example, the bankruptcy court approved an equity holder's request to engage special counsel to represent it in a Delaware chancery court action seeking to compel an annual meeting of shareholders. The \textit{Saxon} court noted that shareholders were entitled to pursue all available alternatives to assert their rights against the debtor, including the election of directors.\textsuperscript{203}

Finally, the Bankruptcy Code provides that instead of appointing a trustee, the court can appoint an examiner to investigate and report on the honesty and competency of the debtor in possession.\textsuperscript{204} Although an examiner's primarily investigatory role\textsuperscript{205} is not akin to that of a trustee, the appointment of an examiner—as well as the prospect of such an appointment—is intended to curb debtor in possession dishonesty, mismanagement, and incompetence.

For several reasons, the ability to replace the debtor in possession is ineffective in addressing the difficulties caused by a separation of ownership and control in bankruptcy. The parties who can seek the replacement of the debtor in possession through § 1104—creditors and equity holders\textsuperscript{206}—are unlikely to galvanize to action because they face both increased monitoring countenanced by § 1104. See, \textit{e.g.}, \textit{In re Gaslight Club, Inc.}, 782 F.2d 767, 769-71 (7th Cir. 1986) (upholding management consent to the appointment of a “[r]esponsible [o]fficer”); \textit{In re United Press Int'l}, 60 B.R. 265, 270-75 (Bankr. D.D.C. 1986) (upholding consent order abolishing the debtor's board of directors); \cf \textit{In re John Peterson Motors, Inc.}, 47 B.R. 551, 553 (Bankr. D. Minn. 1985) (stating that the court's intentions can be accomplished by appointing an examiner instead of a trustee).

\textsuperscript{201} \textit{See In re J.P. Linahan, Inc.}, 111 F.2d 590, 592 (2d Cir. 1940) (stating that “the right of the majority stockholders to be represented by directors of their own choice and thus to control corporate policy is paramount”); \textit{Van Siclen v. Bush (In re Bush Terminal Co.)}, 78 F.2d 662, 664 (2d Cir. 1935) (recognizing power to elect a new board, which will act in conformance with stockholders' wishes).


\textsuperscript{203} \textit{Id.} at 50.

\textsuperscript{204} \textit{See} 11 U.S.C. §§ 1104(b), 1106(b). Pursuant to § 1104(b), an examiner can be appointed when: (a) a trustee is not appointed; (b) a party in interest requests appointment of an examiner; and (c) the debtor's nontrade, nontax, unsecured debts exceed $5 million or “such appointment is in the interests of creditors, any equity security holders, and other interests of the estate.” \textit{Id.} § 1104(b).

\textsuperscript{205} On occasion, courts have broadened the duties of an examiner to include mediation over plan disputes, \textit{see In re Public Serv. Co.}, 99 B.R. 177, 182 (Bankr. D.N.H. 1989); \textit{In re UNR Indus.}, 72 B.R. 789, 793-95 (Bankr. N.D. Ill. 1987), as well as the short-term operation of the business. \textit{See, e.g.}, \textit{In re John Peterson Motors}, 47 B.R. 551, 553 (Bankr. D. Minn. 1985).

\textsuperscript{206} \textit{See} 11 U.S.C. § 1104(a).
costs and an aggravated collective action problem. Even in the rare instances when claimants seek the replacement of debtors in possession, courts treat the appointment of a trustee as an “extraordinary remedy,” and infrequently replace the debtor in possession.

Courts resist appointing a trustee for three reasons. First, courts probably accept implicitly Congress’s belief that reorganizations are likely to be more successful if the “debtor . . . remain[s] in control to some degree.” Second, courts are sensitive to cost concerns regarding the reorganization proceeding and generally avoid appointments that increase the reorganization’s overall cost. Third, courts may be suspicious as to the underlying motive surrounding the request for an appointment of a trustee.

Likewise, the election of a new board of directors and the appointment of an examiner also are rare events. Courts do not permit the replacement of a board of directors by election if such a replacement jeopardizes the overall success of the reorganization. Moreover, since shareholders generally have little to gain in a reorganization, they have little incentive to assure that the debtor in possession makes prudent decisions. Also, courts are not compelled to appoint an examiner and frequently resist doing so.

The final difficulty with the removal of the debtor in possession is that it comes too late in the process. The rare appointment that does take place will usually occur after the debtor in possession has decided to proceed with a reorganization, although a liquidation may be in the other claimants’s best interest.

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207 See supra part II.C.
209 LoPucki, supra note 146, at 264-65; LoPucki & Whitford, supra note 139, at 699-700.
210 H.R. REP. No. 595, supra note 46, at 231.
211 See, e.g., In re Stein & Day, Inc., 87 B.R. 290, 295 (Bankr. S.D.N.Y. 1988) (finding that motion for appointment was simply a tactical response of a creditor to debtor’s previous application to cite creditor for its contumacious conduct).
212 See, e.g., In re Potter Instrument Co., 593 F.2d 470, 475 (2d Cir. 1979) (finding that election of new board would in fact be hostile to the interests of reorganization and therefore ordering delivery of proxies); Haugh v. Industries, Inc. (In re Public Serv. Holding Corp.), 141 F.2d 425, 426 (2d Cir. 1944) (suspending annual shareholders meeting until after deciding whether or not to dismiss an involuntary proceeding); cf. Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville), 801 F.2d 60, 65 (2d Cir. 1986) (allowing shareholders to elect a new board when intent of electing a new board of directors is merely to increase leverage and does not substantially decrease the risk of rehabilitation).
213 See, e.g., In re Revco D.S., Inc., 93 B.R. 119 (Bankr. N.D. Ohio 1988) (stating that “shall” does not require the appointment of an examiner where the debtor’s debts exceed $5 million); In re Shelter Resources Corp., 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983) (refusing to appoint an examiner where debts exceeded $5 million and only other argued ground for appointment was to investigate a settled shareholder derivative action).
interests. Hence, the appointment will not completely alleviate many substantial bankruptcy costs.

IV. A Proposed Solution to the Chapter 11 Dilemma

The Bankruptcy Code fails to address adequately the problem of the separation of ownership and control inherent in the debtor in possession structure. This failure increases indirect bankruptcy costs and hence the overall cost of bankruptcy. This Article posits a two-prong solution to the Chapter 11 dilemma: (1) removing debtors in possession from their role in making Fundamental Bankruptcy Decisions and replacing them with neutral decision makers; and (2) establishing a methodology these new decision makers can employ in deciding whether to reorganize or liquidate the entity.

A. A Revised Debtor in Possession Structure

Chapter 11 currently provides that upon the filing of a bankruptcy petition, a debtor in possession will be authorized to make both Business Activity Decisions and Fundamental Bankruptcy Decisions. As this Article has suggested, vesting the debtor in possession with control over Fundamental Bankruptcy Decisions often creates indirect bankruptcy costs because the debtor in possession makes self-interested decisions, such as choosing reorganization over liquidation, despite the impact these choices have on the entity as a whole.

To solve this dilemma, this Article advocates the creation of a bifurcated debtor in possession structure—a modified Chapter 11—pursuant to which an appointed trustee and prepetition management share in the decision making of the corporation. Under this structure, following an entity’s filing of a petition for Chapter 11 reorganization, the requisite United States Trustee would appoint an independent trustee to make Fundamental Bankruptcy Decisions. Such a trustee would be selected from a pool of qualified applicants who were familiar or had experience with the business or industry at issue, much akin to the way trustees are chosen in a Chapter 7 case. To reduce the possibility of the United States Trustee merely appointing his or her “cronies” to the position of trustee, interested parties, such as creditors and equity-holders, could champion a particular individual on the requisite panel, although the United States Trustee would retain ultimate decision-making authority. The fundamental task of the independent trustee would be to decide if a liquidation or reorganization of the corporation is the proper course of action. Prepetition management, in turn, would continue

215 Under current law, the United States Trustee’s role in a bankruptcy proceeding is intended to be primarily administrative. The United States Trustee is charged with monitoring the proceedings and “prevent[ing] undue delay.” 28 U.S.C. § 586(a)(3)(G) (1988). To this end, the United States Trustee is appointed to direct Chapter 11 creditors’ committees, see 11 U.S.C. § 1102 (1988); 28 U.S.C. § 586(a)(3)(E), and monitor Chapter 11 reorganization plans and disclosure statements; see id. § 586(a)(3)(B).
to play a role in the reorganization proceedings, but only in the capacity of making Business Activity Decisions.\textsuperscript{216}

This Proposed Chapter 11 offers many advantages over the existing Chapter 11 structure. First, and perhaps most importantly, it can arguably be accomplished under the terms of the present statute.\textsuperscript{217} Second, it eliminates management from the role of making Fundamental Bankruptcy Decisions in recognition that self-interested debtors in possession impose indirect bankruptcy costs and the Bankruptcy Code's restraints on debtor in possession indiscretions are ineffective. Third, it assigns to both management and the trustee roles for which they are uniquely suited.\textsuperscript{218}

Management is left to run the debtor's day-to-day business affairs—a position for which they are well-equipped. Management has business expertise and knows the daily activities of the firm, the industry, and the competition. Also, management is familiar with the various parties involved in the debtor's affairs, such as its employees and suppliers, and is well-positioned to negotiate with them. Similarly, the trustee, vested with the authority to make Fundamental Bankruptcy Decisions, possesses the requisite skills to make such decisions. The trustee, under the proposed system, unlike management, does not suffer from the same predisposition to prefer reorganization over liquidation. Moreover, trustees would become adept at making Fundamental Bankruptcy Decisions, as that would be their primary duty.

In some instances, dishonest trustees may prefer to continue with an attempted reorganization because it offers them the chance to recover larger fees than they would earn in a liquidation. To curtail this type of behavior, the United States Trustee or the requisite bankruptcy judge would be vested with the power to review the trustee's decisions if a party in interest challenged the wisdom or legitimacy of such decisions. Although such review might increase the costs of a given bankruptcy proceeding, especially if the trustee's decisions were challenged often, these costs would likely be more than offset by the fact that in the vast majority of cases an unbiased trustee would make prudent Fundamental Bankruptcy Decisions.

The Proposed Chapter 11 structure also restores bankruptcy as a means to curtail managerial incompetency and imprudent risk-taking. The risk of bankruptcy should deter poor managerial decision making by assuring that

\textsuperscript{216} Important, this Article contemplates that bankruptcy courts would retain their ability to replace debtors in possession in their role of business decision maker as well as fundamental bankruptcy decision maker. Thus, in certain circumstances the debtor in possession (management) may play no role in debtor decision making.

\textsuperscript{217} At least one court has adopted this type of arrangement. The court in Chesapeake B&D Ltd. Partnership v. Communications, Inc. (\textit{In Re North Am. Communications, Inc.}), 138 B.R. 175 (Bankr. W.D. Pa. 1992), for example, appointed a trustee to manage matters pertaining to the expenditure of the estate's assets while permitting existing management to continue to run the business's daily business activities. \textit{Id.} at 179-80.

\textsuperscript{218} As discussed previously, this specialization of functions is consistent with the economic theory of the firm. \textit{See supra} part II.B.
managers pay the price for foolhardy decisions. Imprudent managers should face a loss of reputation or the prospect of present and future employment.\textsuperscript{219} The existing Chapter 11 structure mitigates this bankruptcy risk by allowing managers to continue in their positions as debtors in possession. The Proposed Chapter 11, however, places a trustee in the position of deciding whether to reorganize or liquidate, thereby relegitimizing bankruptcy risk and serving to deter management from excessive risk taking.

Several criticisms might be levelled against this bifurcated structure. One might contend, for example, that contrary to Congress's intent,\textsuperscript{220} the Proposed Chapter 11 structure will discourage voluntary Chapter 11 filings because in filing, management faces both an immediate loss of their autonomous control over the entity as well as the long-term possibility of losing their jobs if the trustee decides to liquidate the business. Such an argument, however, fails to survive scrutiny. The Proposed Chapter 11 does not mean that managers \textit{per se} will lose their positions. The trustee might elect to reorganize the entity, rather than liquidate it. Additionally, this structure may have the positive effect of inducing managers to perform their jobs particularly proficiently during the "gap" period between the appointment of a trustee and the trustee's determination to liquidate or reorganize the company. As managers may come to believe, stellar performance on their part may both convince the trustee that the business is viable and that they deserve a position in the reorganized entity. Empirical evidence also undermines the notion that this revised structure would discourage managers from "voluntarily" choosing Chapter 11. Although managers prefer reorganization to liquidation, they nonetheless tend to delay filing any bankruptcy petition "until liquidation of the business through state remedies is imminent."\textsuperscript{221} Finally, to the extent that many entities that file Chapter 11 more appropriately should file Chapter 7, this new structure discourages such misfilings.

A second criticism of the Proposed Chapter 11 structure is that it misallocates decision-making duties. One might assert that a trustee is not well-suited for the role of making Fundamental Bankruptcy Decisions. Alternatively, one might argue that managers should not be permitted to remain in control of the daily business affairs of the corporation but should be replaced in their entire capacity by the trustee.

Both these assertions, however, miss the mark. In the typical bankruptcy proceeding, four parties are positioned to render Fundamental Bankruptcy Decisions: (1) management; (2) the interested parties or claimants (creditors


\textsuperscript{220} See, e.g., H.R. Rep. No. 595, \textit{supra} note 46, at 231.

\textsuperscript{221} LoPucki, \textit{supra} note 146, at 265.
or equity holders); (3) the bankruptcy judge; and (4) the trustee. Of these parties, only the trustee is capable of rendering objective decisions with the requisite level of expertise. Management and the claimants cannot be relied on to make objective determinations regarding fundamental bankruptcy questions because of the bias created by the financial and personal stake they have in the decision rendered. They are likely to choose the option that is in their own interest despite its effects on the other claimants. Moreover, although a bankruptcy judge may be capable of making objective determinations, such judges rarely have either the expertise or opportunity to understand a particular business. Making Fundamental Bankruptcy Decisions is likely to be beyond a bankruptcy judge’s technical expertise.

Likewise, the argument that management should be supplanted completely by the trustee is problematic. Trustees are ill-prepared and ill-equipped to make Business Activity Decisions. They are generally not familiar with either the daily Business Activity Decisions of corporations or its specific operations. To be able to render knowledgeable and prudent Business Activity Decisions would require a substantial investment in time and resources. Undertaking this investment, and its attendant consequences, such as poor decisions, could increase bankruptcy costs and perhaps offset much of the reduction in bankruptcy costs saved from taking some of management’s decision-making authority. In contrast, management is familiar with the daily business activities of the firm, not merely intermittent ones, and hence well-positioned to make Business Activity Decisions.

B. A Proposed Methodology for Trustee Decision Making

The second prong of the Proposed Chapter 11 structure offers trustees a methodology to employ in making Fundamental Bankruptcy Decisions. The basic decision a trustee faces is straightforward: Is the reorganization or liquidation of the entity the preferable course of action? In other words, which alternative is in the best interest of the claimants, as well as other interested parties?

The obvious response to these queries is that the trustee should elect to reorganize the firm if its reorganization value exceeds its liquidation value. Or, algebraically, where $R$ is the present value of the future earnings of the reorganized firm and $L$ is the value of the firm upon liquidation, the trustee should elect to reorganize the entity if $R - L > 0$; and liquidate the entity if $R - L < 0$. That is, the firm should be reorganized if $R > L$, and liquidated if $L > R$.

In microeconomic terms, a successful firm’s average revenues will exceed its average total costs. Average total costs consist of both average variable costs—costs that vary with the number of products produced—and average

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222 This Article recognizes that an examiner might also be placed in the role of fundamental bankruptcy decision maker so long as the examiner is drawn from a pool of qualified examiners and is vested with the powers given to the trustee in this Article.
fixed costs—costs that do not vary with the amount of production or services provided.223 A firm is in financial difficulty, however, if its average revenues fail to cover its average total costs. In this situation, a trustee should attempt reorganization if the entities assets have no readily discernible alternative use and the firm's revenues exceed its variable—but not total—costs.224 Reorganization is proper, in other words, if the fixed costs of the entity can be restructured to bring its total costs in line with total revenue. Likewise, liquidation is the requisite course of action if the firm's revenues fail to satisfy even its variable costs. Restructuring its corporate debt and ownership structure will not help the entity in that instance; the company is not viable.

1. Traditional Approaches—Valuing the Entity

Although the formula the trustee employs in making Fundamental Bankruptcy Decisions is quite simple, the trustee faces a formidable task. The trustee must determine the firm's respective reorganization (R) and liquidation (L) values. Neither of these values can be calculated with "mathematical certitude,"225 but the L value of an entity can be estimated by asking how much bidders would pay for the assets of the corporation at a liquidation sale.226 Determining a reorganized entity's R value is more complex. From an economic perspective, one can find the value of R by projecting how much income can be derived from the assets of the entity in their projected use and discount this figure to its present value. Yet, this value may not accurately capture the complete value of a reorganized entity.

Two competing schools of bankruptcy theory advance widely divergent views regarding the utility of Chapter 11, and hence indirectly the value of a reorganized entity. A survey of these two perspectives, the economic and the value-based accounts, highlights the difficulty in assigning a value to the reorganized entity. Following this survey, this Article will posit a plausible solution to determining an entity's reorganization value.

223 The relationship can be illustrated algebraically as follows: Average Total Costs = Average Variable Costs + Average Fixed Costs.

224 White, supra note 141, at 478 n.3; see Posner, supra note 219, at 377-78 (suggesting that a firm whose revenues exceed its variable costs ought not to be liquidated); see also Avinash Dixit, Investment and Hysteresis, 6 J. Econ. Persp. 107 (1992) (suggesting that it may be sensible to keep a company in business even though its variable costs exceed its revenues because the chance that operations will improve is equivalent to an option contract, the value of which can be used to offset interim losses).

225 See Consolidated Rock Prod. Co. v. Dubois, 312 U.S. 510, 526 (1941) (noting that the company's earning capacity can only be estimated).

226 See Chaim J. Fortgang & Thomans M. Mayer, Valuation in Bankruptcy, 32 U.C.L.A. L. Rev. 1061, 1063-64 (1985) (outlining the basic distinction between "liquidation" value and "going concern" value). As one might imagine, the simplicity of determining the liquidation value of an entity is a bit overstated. See id.
a. The Economic Account

Professors Douglas Baird and Thomas Jackson are the primary proponents of an economic approach to bankruptcy law. Inspired by the law and economics movement, they contend that reduced to its essence, bankruptcy law is simply a response to the problem of collecting debt. In their view, the world is inhabited by economic beings whose actions are both rational and self-interested. The primary goal for such individuals is to acquire wealth by engaging in exchanges with others. Because self-interest drives actors to increase their wealth as much as possible, these actors compete for scarce economic resources.

Although in some situations one actor’s acquisition of wealth may not affect another’s, actual conflict will occur when the actors seek to recover from the same pool of limited resources. A common pool problem results. In this situation, each actor acting individually seeks to extract as much as possible from the common pool, hence undermining the interests of the group of actors as a whole.

As Baird and Jackson theorize, the purpose of bankruptcy law is to address this common pool problem by regulating the process by which individuals make exchanges against a common pool of assets in their efforts to increase individual wealth. As they assert, in regulating these exchanges, bankruptcy law seeks to maximize the outcome for creditors by maximizing the value of the pool. Bankruptcy law accomplishes this goal in two ways.

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227 See generally JACKSON, LOGIC AND LIMITS, supra note 3 (outlining a theory of bankruptcy law); Baird, supra note 3 (criticizing Chapter 11 reorganizations); Baird & Jackson, supra note 12 (developing the theory that bankruptcy law should protect the interests of the claimants as a group).

The Baird and Jackson approach has engendered much debate: some of it highly favorable, see, e.g., Theodore Eisenberg, A Bankruptcy Machine That Would Go of Itself, 39 STAN. L. REV. 1519, 1520-21 (1987) (praising Jackson’s coherent approach to bankruptcy law as set forth in The Logic and Limits of Bankruptcy Law); Robert E. Scott, Through Bankruptcy with the Creditors’ Bargain Heuristic, 53 U. CHI. L. REV. 690, 692-94 (1986) (complimenting Baird and Jackson for “set[ting] the terms of scholarly debate” in their bankruptcy casebook), some of it very critical, see, e.g., Bowers, supra note 5, at 2103-13 (1990) (criticizing Baird and Jackson’s theory of bankruptcy); David G. Carlson, Philosophy in Bankruptcy, 85 MICH. L. REV. 1341, 1341 (1987) (reviewing Jackson’s The Logic and Limits of Bankruptcy Law and stating that all but the most enthusiastic law and economics adherents “will find the book badly wanting”).

228 See JACKSON, LOGIC AND LIMITS, supra note 3, at 3 (“Bankruptcy law, at its core, is debt-collection law.”).

229 Id. at 10-19 (describing the nature of the common pool problem and how bankruptcy law works to alleviate it).

230 See Baird & Jackson, supra note 12, at 110 (describing bankruptcy’s basic goal as preserving “the value of assets for those who own them”); Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 STAN. L. REV. 725, 728 (1984) (“Bankruptcy law is designed to assure that the asset ‘pie’ is as large as possible, given a set of relative entitlements.”).
Through the use of the automatic stay, it prevents individual creditor actions aimed at the immediate dismemberment of the common pool, and through provisions providing for the distribution of assets subject to certain requirements, it provides for a disposition of the pool's assets in a manner by which the maximum value of the assets is realized, either by a "sale" to creditors or third parties.

From these assumptions regarding the purpose of bankruptcy law, economic account theorists assert that corporate reorganizations can only be justified if they "permit[] the claimants as a group to enjoy a larger asset pie than otherwise" so as to increase the size of the common pool. Such a situation occurs, economic account theorists maintain, only when the claimants are willing to pay more for the common pool than third parties. This situation might theoretically arise in a context where "claimants have better knowledge about the value of the firm or [where] valuable contributions are being made to the future well-being of the firm by the various claimants." Yet economic account theorists dismiss the plausibility of such occurrences. As Jackson argues, if the claimants have information regarding the value of the firm, it is unlikely that such information would not also be widely available in the market as well. Jackson also contends that any special expertise insiders possess does not justify a corporate reorganization because in either a reorganization or a liquidation of the entity, purchasers will negotiate with insiders in an attempt to encourage them to remain with the firm.

Economic account theorists view reorganizations as valueless because reorganizations cannot be justified as pool-maximizing events. Some economic account theorists have even gone as far as to suggest that because empirical evidence supports the proposition that both creditors and stockholders lose wealth as a result of a Chapter 11 proceeding, Chapter 11 "should be repealed." In summary, economic account theorists believe that in most situations, an entity's liquidation value should be approximately equal to its reorganization value. Given the relatively greater costs of reorganizing as compared with liquidating and the slight historical probability of success, economic account theorists would drastically discount the R value.

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232 See JACKSON, LOGIC AND LIMITS, supra note 3, at 151 (describing how the automatic stay prevents behavior that might harm the claimants as a group).
234 See JACKSON, LOGIC AND LIMITS, supra note 3, at 210-13 (suggesting that a reorganization is a form of asset sale, the only difference being that in a liquidation, the common pool is sold to third parties, rather than to the creditors themselves as is the case in a reorganization).
235 Id. at 215.
236 Id. at 217-18.
237 Id. at 219-20 (doubting that ability of insiders or judges to value a firm more accurately than the market).
238 Id. at 221-22.
239 Bradley & Rosenzweig, supra note 5, at 1078.
of a reorganized entity to perhaps .5R or even zero. This discounting effect is consistent with their favoring liquidation as a remedy and desiring to repeal Chapter 11.

b. The Value-Based Account

Prominent among critics of the economic account is Professor Elizabeth Warren. She argues that bankruptcy law reflects many concerns, both empirical and normative, which cannot be reduced to a single theoretical construct. In response to the economic account, she offers what she admits is "a dirty, complex, elastic, interconnected view of bankruptcy from which [she] can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision."\(^{240}\) Under her view, bankruptcy is "an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors."\(^{241}\) In distributing these "consequences," Warren does not view the maximization of creditor wealth as the predominant concern. Nor does she regard bankruptcy as being about increasing the size of the creditors' pie. Rather, she maintains, bankruptcy, and specifically corporate reorganization, is an effort to "acknowledge[ ] the losses of those who have depended on the business and redistribute[ ] some of the risk of loss from the default."\(^{242}\) Of particular concern to Warren, is that Chapter 11 further "the distributional interests of many who are not technically 'creditors' but who have an interest in a business's continued existence."\(^{243}\)

Echoing many of the same sentiments as Warren, Professor Korobkin also objects to the economic account; instead he offers a value-based account.\(^{244}\) In Korobkin's view, bankruptcy law is not intended merely as a response to the problem of collecting debt. Instead, it is an attempt to address the "moral, political, personal, social, and economic" aspects of financial distress and the effects such financial distress has on the many parties it affects.\(^{245}\) Korobkin argues that the fundamental thrust of bankruptcy law is to provide "a forum for an ongoing debate in which [the] diverse values [of the participants] can be expressed and sometimes recognized."\(^{246}\) For him, bankruptcy "[I]oosely speaking . . . accomplishes a kind of 'group therapy,' "\(^{247}\) "The value-based account thus explains bankruptcy law as a system with varied contours and dimensions, having the distinct function of

\(^{240}\) Warren, supra note 12, at 811.

\(^{241}\) Id. at 777.

\(^{242}\) Id. at 788.

\(^{243}\) Id. at 787.

\(^{244}\) See Korobkin, supra note 12, at 721.

\(^{245}\) Id. at 721.

\(^{246}\) Id.

\(^{247}\) Id. at 722.
facilitating the expression and recognition of those diverse values important in dealing with financial distress."

Concomitant with the notions that Warren and Korobkin advance is an unstated belief that the value of a reorganized entity cannot be measured merely by the present value of its earnings. In their view, the purpose of corporate reorganization is not simply to maximize creditor wealth, which would maximize the size of the common pool, but also to further other values and interests such as those of tort claimants or members of the community. Because proponents of this account believe that a reorganized entity serves important interests apart from those measured in economic terms, one might expect them greatly to favor reorganization over liquidation. Accordingly, in the equation a trustee faces, one would expect her to assign a very high value to $R$—creating a strong presumption that the trustee will elect reorganization over liquidation.

2. A Process-Based Approach to Valuing the Entity

Both the economic and value-based accounts offer incomplete solutions to the problem of valuing a reorganized corporation. Most fundamentally, each account overstates its case. Under the economic account's rationale, a reorganization would rarely, if ever, occur. By contrast, applying the value-based account's analysis would mean that a trustee would virtually always choose reorganization over the competing choice of liquidation. A new approach that provides principles for determining a realistic value for the reorganized entity is required. Before developing this approach, this Section will offer specific criticisms to the use of either the economic or value-based accounts in valuing reorganized entities.

The economic account's principal failings are that it ignores empirical evidence surrounding Chapter 11 and its legislative history. The economic view, for example, discounts a study, focusing on cases in the southern district of New York, which reported that returns for unsecured creditors from liquidations were at least ten times lower than returns from Chapter 11 plans. Thus, the economic account does not adequately address the conclusion that reorganizations increase the size of the economic pie.

Economic theorists also ignore the legislative history of Chapter 11 and the goals Congress intended to foster by its enactment. As the legislative history of the business reorganization chapter suggests, Chapter 11 was enacted to further goals apart from the mere enhancement of claimants' wealth. The legislative history is replete with discussions of developing policies to "protect the investing public, protect jobs, and help save troubled

248 Id.
249 Id. at 788.
250 Warren, supra note 12, at 788.
251 White, supra note 141, at 484; see STANLEY & GIRTH, supra note 47, at 21-22. But see Bradley & Rosenzweig, supra note 5, at 1071-72 (indicating bondholders suffer significant reductions in wealth attributable to Chapter 11 filings).
businesses;" furthering "overriding community goals and values" in bankruptcy of "the public interest" beyond the interests of the claimants, and acknowledging that it is more "economically efficient" to reorganize than to liquidate. The United States Supreme Court has recognized Congress's consideration of these concerns, stressing the need to interpret the Bankruptcy Code so as to permit the "successful rehabilitation of debtors."

More fundamentally, the adoption of the present Chapter 11 structure and its operation are indicative of a greater intent by Congress to broaden the reach, and hence the purpose, of bankruptcy law. The definition of "claim" was expanded, in "a significant departure from present law," in recognition that "all legal obligations of the debtor [should] be dealt with in the bankruptcy case." In decisions subsequent to the enactment of the Bankruptcy Code, moreover, courts have employed the Bankruptcy Code in addressing a myriad of issues, apart from those of creditor wealth, including the rights of prospective torts claimants and parties to collective bargaining agreements.

If the economic account understates the value of corporate reorganization, the value-based account may well overstate it. Applying the value-based account to firm valuation, one is left to ask if there is ever a circumstance where liquidation is preferable to reorganization. Although the value-based account proclaims the merits of reorganization, it seemingly ignores the possibility that in a given instance a reorganization may also involve costs that compel liquidation.

Additionally, although the value-based account underscores the many


255 H.R. REP. No. 595, supra note 46, at 220. Unfortunately, or understandably, as economic account theorists might maintain, Congress failed to articulate the meaning of "economic efficiency." See Bradley & Rosenzweig, supra note 5, at 1043 n.4.


258 Id. at 5808.


concerns that reorganizations might effectively address, such as the preservation of jobs at a troubled entity, it fails to explain why bankruptcy is the proper forum to appraise these concerns.\textsuperscript{261} As Baird acknowledges, "[o]ne could . . . have a federal statute that prevented any business from ceasing operations" irrespective of bankruptcy.\textsuperscript{262} Bankruptcy, and reorganization in particular, cannot be a forum to cure all of a corporation's or society's ills. There are limits, and a primary failing of the value-based account is that it declines to offer any defining formula for a trustee to apply in determining these limits.\textsuperscript{263}

In recognition of the difficulties inherent in both the economic and value-based accounts, this Article posits a two-step process-based methodology for valuing a reorganized entity. Under this account, the final value of a reorganized entity, and therefore the decision whether to reorganize or liquidate the applicable corporation, is not a product of any particular mathematical formula, but of the Proposed Chapter 11 process and the unique role the trustee plays in such a process. The trustee's valuation is compelled in a sense by the process employed.

This process-based account operates in the following manner. A trustee should be appointed to make Fundamental Bankruptcy Decisions. As noted above, the principal decision a trustee makes in this context is to decide whether to reorganize or liquidate the entity. Also, as discussed, this involves evaluating the firm's worth both as a reorganized or liquidated entity. To determine the reorganization value under the process-based view, a trustee should first consider the expected present value of the future earnings of the reorganized entity—the figure denoted as $R$ above.\textsuperscript{264} Using this figure as a benchmark, a trustee should then adjust $R$ upward to reflect the intrinsic values of reorganization alluded to in the legislative history of the

\textsuperscript{261} Baird, supra note 260, at 828 (noting that other forums exist to remedy these concerns).

\textsuperscript{262} Id.

\textsuperscript{263} Professor Roe has suggested that a possible approach to determining the value of a reorganized entity is to float 10% of the shares of the reorganized entity on the market and then extrapolate the company's value from the sale price for these securities. Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 COLUM. L. REV. 527, 559 (1983).

This approach, however, suffers from at least four limitations. First, this valuation would occur after bankruptcy costs were already incurred, and the entity had already been reorganized. Second, such a solution fails to address the arguments discussed before regarding the inability of the market to value properly all the benefits of reorganization. Third, even assuming the market can value perfectly a reorganized entity, issuing a small float of the entity's reorganized shares might produce an inaccurate figure as some of the participants in the reorganized entity may have incentives to purchase shares at artificial prices so as to manipulate the ultimate reorganization value. Finally, this methodology is only applicable in the case of listed stocks, a relatively small portion of the entities likely to seek bankruptcy protection. Bebchuk, supra note 5, at 790.

\textsuperscript{264} See supra notes 225-26 and accompanying text.
Bankruptcy Code. Values that the trustee should consider include: the number of jobs the reorganization will preserve; the effects a liquidation or reorganization may have on the local community; the likelihood of a successful reorganization; and the effects the decision will have on creditors, stockholders, and other interested parties. If the liquidation can effectively sell the firm as a going concern value, or if there is little going concern value, the trustee should not significantly adjust R. Obviously, the degree to which the trustee will adjust R upward cannot be reduced to a mathematical formula. Rather, the facts and circumstances of each case will shape the degree of the adjustment. In some instances, the adjustment may be quite radical, in others quite minimal.

In assessing the adjusted R value, trustees can rely on the process of adjustment itself to provide guidance. Because trustees will be compelled to engage in this adjustment process, they will gradually become adept at making these evaluations and gain greater expertise. As one might expect, if trustees become familiar with an industry and are selected as trustees with respect to that industry, they will develop an ability to make accurate adjustments. Likewise, as the process of making these adjustments develops, a data pool of information regarding reorganization values will be created for companies and industries. Trustees might also seek independent assessments of the reorganized firm's worth compiled by major accounting or management consulting firms. This data will prove invaluable to trustees in their adjustment determinations.

Notably, in attempting to arrive at the proper value for R, the trustee is engaging in two separate determinations or judgments. First, the trustee is exercising what might be termed a business judgment about the value of the reorganized entity. Second, the trustee is making a purely distributive judgment about how much protection one group, the employees, for example, should receive at the expense of others, such as the creditors. That is, the trustee is balancing and considering the effects the reorganization will have on all the parties involved in the process and then determining an adjusted value for R. In this latter role, the trustee must wear the cap of a judge in equity, akin to the role initially played by judges in courts of equity with respect to the railroad reorganizations discussed earlier.265

Following an evaluation of the various concerns and an arrival at an adjusted figure for the reorganized entity, R, the trustee should compare the reorganization value to the liquidation value of the firm. If the adjusted reorganization value is lower, the firm's Chapter 11 reorganization proceeding should be summarily converted into a Chapter 7 liquidation of the entity. If, however, the firm's adjusted reorganized value exceeds its liquidation value, then the Chapter 11 proceeding will continue. A reorganization plan will be developed at which point the interested parties will determine if the firm's debt and ownership structure can be altered so that the firm can at

265 See supra part I.A.
least satisfy its average variable costs. If the firm cannot be reorganized so
that its revenues meet its variable costs, the firm should liquidate.

In a real sense, reaching a Fundamental Bankruptcy Decision under the
process-based methodology allows a trustee essentially to employ a modified
form of practical reasoning, well-developed in the field of statutory interpr-
etation. Under the practical reasoning model of decision making, the
trustee should consider an array of factors in reaching a decision, from the
broad policies behind Chapter 11, such as preserving jobs, to whether the
particular business at issue is economically viable. In valuing these different
considerations, and hence in formulating a decision, the trustee should weigh
each consideration differently: concrete and narrow considerations should
receive more value than considerations regarding statutory purpose. Thus, if
the business were found not to be economically viable, the decision to liqui-
date would be obvious, despite the purposes of Chapter 11. On the other
hand, if the business were found to be economically viable, then the trustee
should give consideration to the broader purposes behind Chapter 11. The
trustee is essentially exercising some sort of judgment "between the general
standard and the specific case." That is, the trustee is deciding, given the
goals of Chapter 11, whether the particular entity before it is one that is a
viable candidate for reorganization.

This process-based account does not eliminate the possibility that a corpo-
ration filing Chapter 11 will ultimately liquidate. Instead, it promises to
reduce bankruptcy costs by vesting an independent trustee with the initial
determination of whether or not the requisite entity is a viable candidate for
reorganization. After this determination is made, the ultimate structure of
the reorganization plan will determine if the firm is economically viable, and
hence whether a successful reorganization is actually possible. The trustee's
role is to speculate about the applicable values of a given entity. Deciding
whether a reorganized entity is economically sustainable pursuant to a reor-
ganization plan is beyond the trustee's province.

Admittedly, the process-based account is not ideal. Trustees will over-
value the reorganized entity in some instances and undervalue it in others.

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268 To some extent, the likelihood of such overvaluation or undervaluation will be
reduced by the interested parties having an opportunity to "plead their case" to the
trustee. Moreover, the United States Trustee or the requisite bankruptcy judge will
review the trustee's decisions, further reducing the likelihood that political pressure will compel a trustee to misvalue the firm's prospects.
This account, however, removes the biased decision maker—management—from the valuation process. In doing so, moreover, it replaces management with an independent party who will "grow into" the assigned role of fundamental bankruptcy decision maker.

CONCLUSION

Chapter 11 places the management of the enterprise seeking bankruptcy relief in charge of the debtor business, functioning as the debtor in possession. In this role, management must make two principal types of decisions: Business Activity Decisions and Fundamental Bankruptcy Decisions. Business Activity Decisions involve choices about the day-to-day affairs of the business. Fundamental Bankruptcy Decisions, in contrast, are choices regarding the viability of the entity's reorganization.

A dichotomy of ownership and control exists in the debtor corporation because the debtor in possession and the residual claimants are separate entities. This separation of ownership and control produces bankruptcy costs, the deadweight economic costs to the firm of entering bankruptcy. They include indirect bankruptcy costs, such as the costs of choosing reorganization when liquidation is the preferred alternative.

The Bankruptcy Code attempts to address these costs by imposing several constraints on the debtor in possession. First, debtors in possession owe fiduciary duties to the various claimants. Second, the Bankruptcy Code authorizes the creation of creditors' and equity holders' committees to influence managerial decision making. Third, interested parties other than the debtor in possession are permitted to propose reorganization plans. Finally, debtors in possession can be removed and replaced in certain circumstances. None of these solutions, however, offer a viable means to eliminate debtor in possession abuses.

Accordingly, this Article advocates a two-prong solution to the problem of bankruptcy costs. Under the first prong, a bifurcated debtor in possession will be created in which the existing management of the entity will continue in their role of making Business Activity Decisions and an independent trustee will be appointed to make Fundamental Bankruptcy Decisions. The appointment of an independent trustee both eliminates self-interested decision makers from the role of making Fundamental Bankruptcy Decisions and assigns both management and the new independent trustee roles for which their skills are uniquely suited.

Under the second prong, the trustee is provided with a methodology for determining whether to reorganize or liquidate. The trustee first determines the present value of the future earnings of the reorganized firm (R) and the liquidation value of the reorganized firm (L). Then, relying on experience, the trustee adjusts R upward to reflect intrinsic values of the reorganization recognized by the drafters of the Bankruptcy Code. After making this adjustment, the trustee considers the respective values and decides whether to reorganize or liquidate the entity.
The solution this Article posits is by necessity imperfect. It does not promise to eliminate bankruptcy costs entirely. Bankruptcies by their nature are complicated, and hence costly events, described by one jurist as a combination of “a municipal election, a historical pageant, an anti-vice crusade, a graduate-school seminar, a judicial proceeding, and a series of horse tracks, all rolled into one.”269 It does, however, promise to make them less costly—a step clearly in the right direction.
