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Absolute and Relative Priority Reconsidered: An Essay on the Conceptual Foundations of Corporate Reorganizations

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> The old doctrine of absolute priority is probably not well adapted to the corporate form of organization, and its place may properly be taken by a modified form of the doctrine of relative priority.
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> James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization,* 28 Colum. L. Rev. 127, 165 (1928).

Introduction

The modern law of corporate reorganizations rests on a seemingly unobjectionable analogy to a real estate foreclosure. If a landowner defaults on a mortgage, the senior lender forces a sale of the land to a third party. The proceeds of the sale are used first to satisfy the loan of the senior lender, and then the junior lenders in

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the order of their contractual priority. In the unlikely event anything is left, the balance goes to the debtor. A foreclosure is a day of reckoning. All claims are accelerated and the asset itself is converted into cash. The cash is distributed in a strict, hierarchical manner. The land becomes the property of the highest bidder at the sale, and that bidder is free to impose whatever capital structure she sees fit on the property.

This idea has been transplanted to corporate reorganizations with little change. The reorganization is an event of default that makes all of the firm's debts due and owing. Instead of a sale to a third party, we have a restructuring in which creditors exchange their old claims for new rights against the firm, but this process is commonly viewed as a hypothetical sale of the firm, a sale at which the creditors submit the highest bid. When, as is almost always the case, the firm's assets are worth less than what creditors are owed, the old shareholders should be wiped out, just as they would have been had there been a sale to a third party. The challenge in reforming the law of corporate reorganizations lies primarily in devising a mechanism for valuing the firm and a process that allows us to respect priority rights when there is not a sale in the market.[1]

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[1] We might depart from absolute priority to protect tort victims, and others who might not fully adjust to the presence of senior claimants. See Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 Yale L.J. 857 (1996). Nevertheless, absolute priority provides our baseline. Lucian Arye Bebchuk & Jesse M. Fried, A New Approach to the Valuation of Assets in Bankruptcy (September 2000 Working Paper).

This view of a reorganization as a day of reckoning on which there is a hypothetical sale of the firm has become a fixture of bankruptcy scholarship.[2] The move from conceiving of reorganization as a hypothetical sale to the commitment to absolute priority rule appears short and straightforward. In a foreclosure, old owners receive proceeds in accordance with the priorities that they have set out in their contracts. Priority is strict and absolute. Nothing in the hypothetical nature of the sale demands that we lessen our adherence to absolute priority. Indeed, much work of the last two decades has been devoted to devising systems that implement this notion of absolute priority more cleanly than the current Bankruptcy Code, where, it is thought, cumbersome procedures lead to undesirable departures from absolute priority.[3]

Building a reorganization regime with absolute priority as its foundation suffers from two problems. The first is that treating a reorganization as a hypothetical sale does not lead inexorably to the adoption of a rule of absolute priority. The

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[2] See, e.g., Robert C. Clark, The Interdisciplinary Study of Legal Evolution, 90 Yale L.J. 1238, 1250-54 (1981); Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. Legal Stud. 127 (1986); Elizabeth Warren, A Theory of Absolute Priority, 1991 Annual Survey of American Law 9, 11 n.6.

[3] See Barry E. Adler, *The Emergence of Markets in Chapter 11: A Small Step on* North LaSalle Street, 8 Sup. Ct. Econ. Rev. 1, 9-11 (2000); Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 Stan. L. Rev. 311 (1993); Barry E. Adler & Ian Ayres, A Dilution Mechanism for Valuing Corporations in Bankruptcy (September 2000 Working Paper); Philippe Aghion, Oliver Hart, & John Moore, The Economics of Bankruptcy Reform, 8 J. L. Econ. & Org. 523 (1992); Lucian Arye Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L.

standard story fails to distinguish between the old owners of the firm as sellers and the old owners as buyers. Foreclosure law strictly constrains the distribution of proceeds to the sellers of the property; it places, at best, modest limits on the buyers of the property. Fraudulent conveyance law may police the price that the buyers pay, and guard against sham transactions, but little else. Viewed from this perspective, foreclosure law places no impediments on the capital structure of the asset after sale. It is thus odd that foreclosure law, when transplanted to the reorganization setting, is taken to limit how the cash flow and control rights of the new firm are allocated. There may well be reasons for constraining the participation of erstwhile shareholders in the reorganized entity. These reasons, however, cannot emanate from an analogy to a sale of the firm.

As a matter of actual reorganization practice, the absolute priority rule exists uncomfortably with a persistent and pervasive feature of the capital structures of all but the largest firms. In these smaller firms, there is a near identity between shareholder and manager.[4] These managers, by and large, tend to continue with the reorganized firm. This continuation is not necessarily a cause for alarm. If the manager's contract were properly drawn, she should be dismissed or retained on the basis of her performance and the operational needs of the firm, not on whether the

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Rev. 775 (1988); Mark J. Roe, Bankruptcy and Debt: A New Model of Corporate Reorganization, 83 Colum. L. Rev. 527 (1983).

firm needs a new capital structure. If the manager is responsible for the sorry condition in which the firm finds itself, she should be fired. If she is not responsible, she should continue to run the firm as before and, to ensure her incentives are correctly aligned, she needs to continue to have an equity interest in the firm.[5] The need to reorganize the firm should change neither the amount we pay her nor the need to pay her in equity. Indeed, when we treat the reorganization as a day of reckoning, we generate bad incentives. Faced with the prospect of being wiped out, the manager looks for ways to postpone it, is tempted to take excessive risks, and searches for opportunities to entrench herself. When a reorganization leaves her interest unaffected as long as she does a good job, her incentives are aligned with those of the firm. She tries to do the best job she can.

In this paper, we reexamine absolute priority by contrasting it with another principle—relative priority—that provides an alternative and equally coherent view of corporate reorganizations, one in which the equityholders are not wiped out. The priority that debt enjoys over equity has a temporal dimension. It requires that cash be applied to debt first, but only at a certain time. A debtholder whose claim does not mature for a number of years cannot complain when equity holders retain

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[4] See Venky Nagar, Kathy Petroni & Daniel Wolfenzon, *Ownership Structure and Firm Performance in Closely Held Corporations,* working paper (June 2000) (84% of closely held firms examined had four or fewer stock holders).

[5] The definition of "manager" here is somewhat ambiguous. It can either be the person who actually runs the firm on a day-to-day basis, or the person who monitors closely the person who runs the business.

an interest in an insolvent firm. Only by making the debt due and owing can the debt claim priority over equity.

The law of corporate reorganization could be built on the premise that the reorganization is not a day of reckoning for the equityholders, even though it reduces the claims of the senior debtholders. It is possible to have a law of corporate reorganizations that, in effect, recognizes the option value of the shareholders' interest in the firm.[6] In the absence of a recognition event, the equity in an insolvent firm trades for a positive price. A reorganization regime can leave the value of a shareholder's interest in the firm unaffected.

A law of corporate reorganizations built on the principle that the reorganization is not a recognition event does not suffer from a number of deficiencies associated with the absolute priority rule. Primarily, it allows the manager's incentives to be set by her compensation contract rather than the imposition of a new capital structure. To the extent that the optimal employment contract properly aligns the manager's incentives with those of the firm, this alignment would remain unaffected by a reorganization. Managers would not entrench themselves, nor would they invest in projects that had the expectation of decreasing the value of the firm in exchange for a small chance of winning big.

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[6] See Robert T. Swaine, Reorganization of Corporations: Certain Developments of the Last Decade, 27 Colum. L. Rev. 901, 912-23 (1927); James C. Bonbright & Milton M. Bergerman, Two Rival Theories of the Priority Rights of Security Holders in a Corporate Reorganization, 28 Colum L. Rev. 127, 132 (1928).

The privileged position that absolute priority enjoys in current discussions of bankruptcy is a mystery. As elsewhere in the law, we can begin by asking how investors would shape their contracts if they were free to bargain over them. Creditors have never been able to contract freely over their reorganization regime, but we came closest in the early days of corporate reorganizations, and it is that period to which we turn first. [7] We then go on to reexamine the modern absolute priority rule and show that, notwithstanding its considerable virtues, it is compelled neither by contract nor by logic, especially when there is a near identity between managers and shareholders. With respect to these closely held firms, the alternative priority paradigm provides a better starting place for analyzing the reorganization of these firms. Finally, we explore the implications that this alternative conception of priority has for extant law and practice.

I. Equity Receiverships and the Relative Priority Paradigm

A. The Origins of Corporate Reorganizations

The law of corporate reorganization law evolved along with this country's railroads. The period between 1865 and 1890 was one of enormous growth for the

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[7] Excellent accounts of the evolution of modern law, can be found in John D. Ayer, Rethinking Absolute Priority After *Ahlers*, 87 Mich. L. Rev. 963 (1989); Randolph J. Haines, The Unwarranted Attack on New Value, 72 Am. Bankr. L.J. 387 (1998); David A. Skeel, Jr., An Evolutionary Theory of Corporate Law and Corporate Bankruptcy, 51 Vand. L. Rev. 1325, 1353-76 (1998).

railroads.[8] The period also saw the consolidation of different lines in haphazard and unpredictable ways. Over 75,000 miles of track were laid down in the 1880s.[9] Competition among the different lines intensified; cartels came into existence and then fell apart. It was a time increasing, but unpredictable government regulation, the most important of which were the Interstate Commerce Act of 1887 and the Sherman Act. This was also an era of one of the country's worst economic downturns. All these factors created an industry in which many firms had debt obligations they could not meet. In the late 19th Century, over half of the railroad track in the United States went through reorganization, some more than once.[10]

Even though their liabilities exceeded assets, these railroads were worth keeping intact as going concerns. Once a railroad is built, much of the cost is sunk and there are no alternative uses for the assets (the long, narrow strips of real property, the rails, the bridges, and the ties). It might make sense to sell off parts to other roads or to acquire lines from others, but the basic shape of the firm would remain

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[8] For a general history of the role that railroads played in developing American law, see James W. Ely, Jr., Vanguard for Change: A Legal History of the Railroad Industry (Kansas Press 2001)

[9] For a discussion of the intense competition among railroads, particularly those connecting Chicago with New York during this period, see William Cronon, Nature's Metropolis 81-93 (W.W. Norton & Co. 1991).

[10] In 1893 alone, 27,000 miles of track in the United States went into receivership, more than existed in all of Britain at that time. See Stuart Daggett, Railroad Reorganization at v (Harvard University Press 1908). See also Alfred D. Chandler, Scale and Scope: The Dynamics of Industrial Capitalism 53 (Harvard University Press 1990).

unchanged. Liquidation of the firm, which would distribute the meager returns from sale among creditors, was not a sensible option.

Dealing with the financial distress in which the railroads found themselves, however, was not easy. The capital structure of the railroads was Byzantine. Railroads were initially built and financed in stages. Each stage was financed through mortgages whose form paralleled that of conventional real estate mortgages.[11] Upon default, the bondholders had the right to foreclose on their collateral (a particular stretch of track or a particular building). Over time, railroads merged and formed large networks. The capital structure of these large enterprises, the first firms ever assembled whose capital outlays exceeded $100 million, was a patchwork of many different kinds of bonds, often held by investors in Europe.[12]

The bonds themselves gave the bondholders the right to seize the collateral, but such a right had little attraction in a context in which the collateral—a ten-mile

[11] The financing of railroads until the 1850s was primarily through the sale of common stock. See Alfred D. Chandler, Jr., Patterns of American Railroad Finance, 1830-50, 28 Business History Rev 261 (1954). The need for debt financing arose with the tremendous expansion of railroads after that time. See Peter Tufano, Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century, 71 Business History Rev 1, 22-23 (1997). Moreover, state investment figured prominently in the early financing of railroads. See Stephen Salsbury, The State, the Investor, and the Railroad (Harvard 1967).

[12] See William Z. Ripley, Railroads: Finance and Organization 2-9 (Longmans, Green & Co. 1915); Augustus J. Veenendall, Jr., Slow Train to Paradise: How Dutch Investors Helped Build American Railroads (Stanford 1996).

stretch of track between nowhere and nowhere—had little value.[13] The contract offered no guidance as to what to do when the railroad remained in business.[14] Such silence is hardly surprising. At the time many of the investments were made, there had never been any multi-million dollar firms, let alone any that needed to be reorganized. The circumstances of the Atchison, Topeka, and Santa Fe were typical. By 1889, the Atchison, Topeka, and Santa Fe had become a railroad that connected the American Southwest with the west coast, the Gulf coast, and Chicago. The system had 7,010 miles of track, almost half of what existed in Britain at the time. The line was economically viable; its operating revenues exceeded its operating expenses by $6 million. But these net earnings were insufficient to pay fixed interest costs and would likely remain so. Its outstanding debt, however, totaled $164 million.[15] Net revenues were thus well below 4% of outstanding debt. The firm was thus economically viable—its operating revenues exceeded its operating costs—but insolvent.

The forty-one different types of bonds of the Atchison, Topeka & Santa Fe each gave creditors the right to foreclose on particular assets of the railroad. But the bonds did not provide for any procedure to adjust the rights of each bondholder

[13] See Ripley, *supra* note --, at 126.

[14] This point was largely missed by the academics who studied it. For an early and conspicuous exception, see Edward H. Levi, Corporate Reorganization and a Ministry of Justice, 23 Minn. L. Rev. 3, 19 (1938).

[15]See Stuart Daggett, supra note 8, at 198-200.

relative to the others when none of the bondholders viewed foreclosure as a sensible alternative. Nor was there a legal mechanism designed for this purpose. Congress had the power to enact a bankruptcy law, but at this time no such law was in place. The laws of the individual states simply could not resolve the financial distress of railroads that spanned the continent.

In the absence of specific contractual provisions or legal rules, the railroad's investors had to rely upon an extra-legal, noncontractual mechanism to protect themselves. When sophisticated European investors put their money in the railroads, they understood that railroads were a risky technology whose future was unpredictable. Because they held diversified portfolios, they had no a priori commitment to one distributional rule or another in the event of a reorganization. Rather than specify what should happen in the wake of events that no one could predict, they expected their agents to create both the procedures and the substantive rules that would maximize the value of the assets when firms encountered financial distress. They turned to the investment bankers that had arranged their investments in the first instance. They were charged with the task of monitoring these railroads and orchestrating a reorganization when it was needed.[16] Investors could

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[16] Investment bankers were able to monitor the firms because they served on the board of directors. For a general account of the work of investment bankers and their lawyers in equity receiverships, see Robert W. Gordon, Legal Thought and Legal Practice in the Age of American Enterprise, 1870–1920, in Gerald Geison, Professions and Professional Ideologies in America (University of North Carolina Press 1983).

rely upon investment bankers and their lawyers to look out for their interests. The investment banker's livelihood depended on convincing future investors to invest in the bonds that they sold. As long as J.P. Morgan and Paul Cravath proposed restructurings that were in the joint interest of the bondholders, the bondholders would continue to trust them with their money. Investment opportunities that J.P. Morgan brought to Europe commanded a premium in part because Morgan was well-known for his ability to sort out the mess when things went badly.[17]

During the period of the equity receivership, it was simply not helpful to ask what the written contract provided for. Bond covenants did provide that a bondholder was entitled to payment in full when its collateral was sold in a piecemeal liquidation, but such a liquidation was both grossly inefficient and desired by no one. One could argue that the bondholder was entitled to priority in a reorganization on account of the priority that would be enjoyed in a liquidation, but it is at best an argument by analogy. Liquidation generates a pile of cash, and the only question is distributing that cash. The investors retain no continuing relationship amongst themselves.

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[17] J.P. Morgan took the lead in reorganizing the Santa Fe, the Erie, and the Northern Pacific among others. See Alfred D. Chandler, The Visible Hand: The Managerial Revolution in American Business 171 (Harvard University Press 1977). See also J. Bradford De Long, *Did J.P. Morgan's Men Add Value?,* in Inside the Business Enterprise: Historical Perspectives and the Use of Information (1991) (concluding that participation by Morgan increased value of common stock by as much as 30%); Carlos Ramirez, *Did J.P. Morgan's Men Add Liquidity? Corporate Investment,*

Reorganizing a firm requires not only distribution of future cash flows, but also the assignment of control rights. Besides the bondholders, there were few other creditors. Suppliers of coal and the like were paid on an ongoing basis.[18] Because these obligations were small relative to the amounts owed the investors and because their cooperation was important to keeping the railroad running, these suppliers were typically paid in full at the outset and they played no role in the reorganization.[19] But some one has to be in charge of operating the enterprise. The investment bankers and their lawyers had to deal with the managers of these firms. The managers of the railroad were for the most part the insiders who built and operated the railroad and who formed alliances and cartels with other railroads. They controlled the railroads and held a portion of the railroad's shares.[20] Sometimes they were dishonest and corrupt and needed to be thrown out. More often, they were highly skilled managers who knew how to run the railroad and keep it part of

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Cash Flow, and Financial Structure at the Turn of the Twentieth Century, 50 J. Fin. – (1995) (Morgan's participation likely lowered the cost of capital)

[18] The cash for these outlays came from the issuance of receivership certificates. There was a market for these certificates because they were accorded priority above existing mortgages. See Ripley, *supra* note --, at 385-86.

[19]The practice was to pay debts for labor and supplies incurred in the ordinary course in the six months before the reorganization began. See Fosdick v. Schall 99 U.S. 235 (1878).

[20]They did not, however, own anywhere near a majority of the shares. As with bonds, much of the financing for shares came from abroad. Between 1890 and 1896, foreigners held between 21% and 75% of the common stock in the following railroads: Illinois Central (65%), Pennsylvania (52%), Lousville & Nashville (75%), Reading (52%), Great Northern (33%), and Chicago, Milwaukee & St. Paul (21%), Ripley, *supra* note --, at 5.

a larger network. The investment bankers (and the European investors) were hard put to run the railroad or do the restructuring without their help.

The investment bankers discovered that the best legal mechanism available to them was the equity receivership. In the 19th Century, the equity receivership was used by creditors when ordinary methods of debt collection did not work. If, for example, the assets were sufficiently spread out or required on-going oversight, it would not be sensible to have the sheriff seize them under a writ of execution and then hold a sale. Instead, the creditors would invoke the equitable powers of the court and ask it appoint an individual to take control of the debtor's assets and orchestrate their sale. The person was called a "receiver." The procedure is flexible, and J.P. Morgan and his contemporaries figured out how to use it to give railroads a new capital structure.

The process started when a friendly unsecured creditor, at the suggestion of the investment banker, asked a federal judge to appoint a receiver to take control of the assets of the railroad. The receiver the judge appointed, again at the prompting of the investment banker, would typically be the insider shareholders who were already running the firm.[21] The receivership changed the source of the existing manager's power to run the railroad, but not their ability to run it. As a practical matter,

[21] In a study of 150 railroad receiverships between 1870 and 1898, insiders were appointed as the receiver in 138 cases. See Swain

the investment bankers had no other options. No one else knew where the assets were or what deals existed with the other systems.[22]

Once the receivership was established, dissident creditors could no longer threaten to seize the railroad's assets, as the railroad was now, in theory at least, in the control of the court through the receiver it had appointed. At this point, the investment banker asked the bondholders to give their proxies to a committee established for their type of bond. The committees would then meet with each other and establish what was called the reorganization committee.

Despite the fact that the reorganization committee was comprised of the owners of the firm, they were not acting as passive sellers at a foreclosure sale. Rather, they were acting as a consortium that was to buy the property at the sale The reorganization committee held the proxies of all the individual committees, and it was charged with crafting the entire reorganization plan. The dynamics of the negotiation were affected by the foreclosure procedures. The court would hold a sale. At that time, the reorganization committee would submit its bid. This bid had to exceed the upset price established in advance by the court. The proceeds from the sale would be distributed in order of contractual priority. The reorganization committee, however, did not have to raise cash equal to the amount of its bid. Rather, bondholders and shareholders that agreed to participate in the reorganiza-

[22] See Ripley, *supra* note --, at .

tion had agreed in advance to exchange their proceeds from the sale for the rights specified in the plan of reorganization.

Thus, the threat that each bondholder had was that he would insist on cash rather the rights accorded under the reorganization plan. The more dissenters, the more cash that the committee actually had to raise. The need to keep dissents to a minimum lead to the reorganization committee drafting a plan that reallocated rights among the bondholders in a way that reflected the approximate value that their collateral brought to the firm as a whole.

The plan usually involved more than the reallocation of claims against the firm. Railroads, at the time they were in a receivership, tended to be strapped for cash. A crucial element of the plan of reorganization was to ensure that there was sufficient cash added to the operations.[23] Such cash came from the holders of claims against the line. Indeed, it was often the case that the participation of junior creditors in the new entity depended on their making a fresh capital contribution.

Once a plan had been formed, the receiver would hold a sale of the railroad and distribute the cash proceeds to the bondholders. Anyone could bid at the sale, but the outcome was entirely foreordained. The reorganization committee controlled the overwhelming majority of the bonds. This meant that most of what it bid for the firm would immediately be returned to it. Moreover, the bondholders had

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[23] See Ripley, *supra* note --, at 392-93.

agreed, in advance, to "buy" new securities in the reorganized firm with their proceeds from the sale. Hence, the committee could, for all practical purposes, bid whatever it wanted, up to the total amount of the indebtedness of the firm. Even if the firm were worth more than what the bondholders as a group were owed,[24] no one else during this period could amass the tens or hundreds of millions of dollars needed to make a competing bid.

Once the reorganization committee acquired the property of the old firm at the sale run by the receiver, it placed it in a new firm and redistributed rights in the new firm to the old bondholders according to the plan that the committee had negotiated amongst its members. The new stock, however, did not go directly to shareholders. Rather, it was usually placed in a voting trust.[25] The trust, in turn, was controlled by the investment bankers who had initiated the reorganization in the first instance. The terms of the trust were that it was to last the shorter of five years or until the first dividends were paid on the stock. The effect of this arrangement was to ensure that the investment bankers – whose allegiance ran to both bondholders and stockholders – maintained close control of the railroad's managers in the period immediately following the reorganization.

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[24] This possibility seems most unlikely. In such a situation, the bondholders would benefit at the shareholders' expense. Equityholders, however, had a large voice in the proceedings and acted inconsistently with the idea that the receivership transferred wealth from them to bondholders.

[25] See Ripley, *supra* note --, at 403-04.

To be sure, the reorganization committee had to put some cash on the table.[26] The reorganization plan allowed disaffected bondholders to choose between rights in the new firm or their pro rata share of the proceeds of the sale, but the amount the reorganization committee bid was so low that bondholders were better off taking the new rights and then selling them. While the sale had to be formally approved by the judge as "fair," judges as a practical matter were unwilling to upset a deal agreed to by the vast majority of the security holders.[27]

This reshaping of the equity receivership allowed railroads with debt obligations that were inconsistent with the firm's projected revenue to emerge from the reorganization with a sensible capital structure. The number of bonds would be dramatically reduced and the new securities (such as preferred stock[28]) allowed the investors to receive income if earned, but not trigger a default if it were not.[29] Indeed, the continuing control of the investment bankers ensured that the managers of the railroad had a period of time to operate without having to answer to any in-

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[26] This cash often came from the old shareholders. The shareholders were often given the right to buy a new interest in the reorganized entity at a bargain price.

[27] Check to see if this "fair" requirement also has roots in the foreclosure sale.

[28] Preferred stock was popularized through its extensive use in railroad reorganizations. See Tufano, *supra* note --, at 22-23.

[29] See Ripley, *supra* note --, at 393 ("A permanent reduction in fixed charges, that is to say interest on funded debt, is the next [after raising of cash] essential of any successful reorganization plan.").

vestors other than the investment bankers. Managers had to worry about their performance, not about actions from disparate creditors.

This procedure, cobbled together by professional investors with their money and reputation on the line, proved remarkably effective. To return to the example of the Atchison, Topeka & Santa Fe, the classes of bonds were reduced from forty-one to two, both of which had very long terms. The new capital structure proved sound, and the railroad thrived. The principal on the last of the bonds was repaid on schedule in 1995.[30]

As noted, this reorganization mechanism included a judicial sale, but this was an artifact of the need to conform to the formal dictates of the equity receivership, not from anything required by the bonds themselves or their owners. The judicial sale and distribution of proceeds extinguished the old claims against the firm. This elimination was necessary to ensure implementation of the new capital structure. Over time, the judicial sale increasing became a legal fiction, and, by the 1930s, the pretense of an actual sale was dropped altogether. What was left was a negotiation among the firm's investors, orchestrated by the firm's lawyers and investment bankers. Old shareholders were given the option to purchase shares in the reorganized firm, usually at a bargain price. What was crucial was that the deal

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[30] See Daggett, supra note 8, at 213. See Floyd Norris, "After 114 Years, It's Payday," New York Times at 17 (July 1, 1995).

that they were offered was not "too good." The relative priority among the respective security holders had to be maintained.

Nevertheless, the notion that a corporate reorganization is a hypothetical sale of the assets of a firm—and thus called for application of the priority rights that invariably follow an actual sale—colored much of the thinking about the law of corporate reorganizations and it still does.

B. A Reorganization as a Day of Reckoning

The absolute priority paradigm has become so dominant over the past several decades that many have forgotten that the relative priority paradigm dominated reorganizations practice for decades.[31] By the end of the 1920s, it seemed that the link between the real estate foreclosure and corporate reorganizations would be severed.[32] At this point, however, a small group of young lawyers and academics launched a concerted attack on the relative priority principle and strongly advo-

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[31] Exceptions include Ayer, supra note 5; Haines, supra note 5; Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 Stan L Rev 69, 84-85 (1991); Skeel, supra note 5.

[32] See, e.g., Bonbright & Bergerman, supra note 4, at 165; Swaine, supra note 4. Swaine remains the foremost exponent of the relative priority rule. His articles, however, are not easy to penetrate, as he did not have the benefit of the tools of modern finance. It was easy to dismiss his work as self-interested and incoherent, as many did. In a previous paper, we examined Swaine's contribution to the law of corporate reorganizations. See Douglas G. Baird & Robert K. Rasmussen, *Boyd's* Legacy and Blackstone's Ghost, 1999 Sup. Ct. Rev. 393. During his own time,

cated reforging the link with real estate foreclosure law.[33] In their view, relative priority lacked coherence.[34] It was a device primarily aimed at enriching corporate insiders, lawyers, and bankers at the expense of the public investor. A doctor in Peoria invested his savings in a railroad bond and, when the firm was reorganized, insider shareholders took advantage of the investor's lack of sophistication and distance from the scene while reorganization professionals generated enormous fees. Abuses were laid out both in an 8-volume government study[35] and a best-selling exposé.[36]

Swaine was subject to much self-righteous invective and abuse, and Swaine's contributions to the law of corporate reorganizations remain largely unrecognized.

[33] See, e.g., Jerome Frank, Some Realistic Reflections on Some Aspects of Corporate Reorganization, 19 Va. L. Rev. 541 (1933); Address of Abe Fortas, Assistant Director of the Public Utilities Division, Securities and Exchange Commission, July 14, 1938, New York, N.Y., at p. 8.

[34] Economists shared this view as well. See, e.g., Norman S. Buchanan, The Economics of Corporate Reorganization, 54 Quarterly J. Econ. 28, 40 n.6 (1939).

[35] See Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937).

[36] See Max Lowenthal, The Investor Pays (Knopf 1933). Thurman Arnold paints the following picture:

> Large fees in such situations are the rule rather than the exception. Generally counsel fees in reorganizations constitute the largest single item for all service and usually exceed the compensation of the officers or groups which the attorney represents. The fees represent high-class boondoggling and bureaucratic red tape of so complicated a nature that it is almost impossible to say at what point they are unjustified. Moral judgments can scarcely be made. In addition to fees, key places in any reorganization offer opportunities for distribution of valuable patronage. The stakes of participation in reorganization

When these lawyers and academics took prominent positions in government, they implemented these ideas. Investment bankers and their lawyers were pushed out of reorganization practice, managers who led publicly held firms into bankruptcy were to be terminated, and the bankruptcy laws were interpreted to mandate absolute priority. Whatever merits the absolute priority rule might have, its origins do little to give one confidence that it is a sensible rule. The basic premise that led to its introduction—that relative priority harmed public investors—was wrong. We now know that public investors who held diversified portfolios of these sorts of bonds over the long haul systematically outperformed the market.[37] These same lawyers and academics that attacked relative priority also thought it sensible to limit the influence of investment bankers and enacted rules that prevented them from overseeing the reorganization of firms for which they had raised the funds

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> have become so high that they often are a greater objective that the reorganization itself.
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> The situation is very similar to the control of a municipal government by a political machine, with the possible exception that the public opinion does not permit politicians to take any such percentage of the income of the municipality which they control.

Thurman W. Arnold, The Folklore of Capitalism 258-59 (Yale U Press, 1937).

[37] W. Braddock Hickman, Corporate Bond Quality and Investor Experience (Princeton 1958).

initially.[38] They failed to understand the bonding mechanism that exists when the person reorganizing the firm must return the same investors for capital.

II. Revisiting the Creditors' Bargain

One response to recognizing the option value of the shareholders' interest in an insolvent firm might be that the terms of the firm's debt contracts put a different distributional scheme in place. The absolute priority rule better reflects the bargain that the creditors have struck with the firm.[39] The strange capital structure of the railroads made it hard to sort out priorities among creditors, and generally applicable mechanisms of corporate governance were underdeveloped. The equity receivership allowed for the imposition of a more sensible capital structure and allowed investment bankers to monitor the actions of managers. Today, firms generally have clean capital structure, and corporate law allows shareholders to monitor managers. We are left with the fact that each creditor bargained for the right to be paid in full before shareholders receive anything. There is no reason to substitute the relative priority contract for the investment contract that the parties wrote.

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[38] See David A. Skeel, Jr., The Rise and Fall of the SEC in Bankruptcy, University of Pennsylvania Law School Institute for Law and Economics Working Paper No. 267, 5-12 (Nov 1999).

[39] See, e.g., Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857 (1982).

This characterization of the problem, however, glosses over an important ambiguity in the contractual agreement between creditors and the firm. Consider the following hypothetical. Manager runs Firm and, as Firm's sole shareholder, is entitled to its residual earnings. Investor makes a capital contribution to Firm at t=0. At t=1, we shall learn information about Firm's future. We shall be either in a good or bad state of the world, each of which is equally likely. In the good state, Firm will be worth $300 with certainty at t=2. In the bad state, Firm will be worth $300 with one-third probability and nothing with two-thirds probability. Firm's contract with Investor requires it to pay Investor the lesser of $150 or the value of its assets at t=2. If we are in a bad state at t=1, there may be a recapitalization of Firm. In the event of a recapitalization, Investor's interest will be transformed into equity equal in value to the interest in Firm that it is then holding.

Let us assume that we find ourselves in the bad state of the world. How much equity should Investor receive in return for its right to receive $150 at t=2? Investor's contract contains an important ambiguity. One can argue that Investor should receive 100% of the equity of Firm. Under one view, Investor has a right to $150 and Firm has an expected value at t=2 of only $100 (the expected value of getting $300 one-third the time and nothing the rest). Given that Investor is entitled to $150, it should receive all the equity of Firm. Investor is entitled to be paid in full before Manager receives anything. If Firm is worth less than what Investor is owed, Investor should get everything. Anything less undercuts the idea that Investor's rights against Firm enjoy priority over Manager's. This interpretation of the contract

between Firm and Investor corresponds to the dominant view of corporate reorganizations.

An alternative interpretation is also possible, however. It too is consistent with the ultimate right of the creditors to be paid before equityholders. Investor is entitled to $150 only at t=2. A recapitalization at t=1 does not entitle Investor to insist upon rights that it has only at t=2. No one is being paid at t=1. Investor's share of Firm in a recapitalization at t=1 should reflect the present value of its interest at t=1. In bad states of the world at t=1, Investor has a one-third chance of being paid $150 and a two-thirds chance of being paid nothing. Its interest at t=1 is therefore worth $50. As the expected value of Firm at t=2 is $100, to have its interest respected, Investor should receive an equity stake of 50% in a restructuring at t=1. Investor enjoys a right to be paid in full *at t=2*. We recognize the full value of that right *at t=1* by giving Investor an interest in Firm that is worth $50. The relative priorities of Investor and Manager at t=1 are maintained.

It is one thing to note that there are two plausible characterization of a debt contract upon reorganization—absolute priority and relative priority. It is another to show that investors prefer one or the other. Choosing between these two interpretations of the debt contract is not easy in the abstract. There are, of course, reasons to accept the idea that the reorganization should be a recognition event. Once we decide that it should be, the absolute priority rule follows quite naturally. If we treat the reorganization as a recognition event, no other distributional rule has clean

contours nor is any other rule consistent with the general idea of that debt enjoys priority over debt.

The case for absolute priority is strongest with respect to modern large, publicly traded firms with their neatly hierarchical capital structures. The simplicity of the rule in this setting may be its greatest virtue.[40] Among investors in large, publicly traded firms, there is no need for more complex instruments. Any investor who wants an investment contract that provides for a different priority can create it by combining the right mixture of puts and calls.[41] Even if we assume that creditors are better off with an investment contract that provides for something other than absolute priority, absolute priority among creditors may still be the better rule.

The development of thick equity markets and robust control of managers in the last century eroded many of the animating forces behind the equity receivership. No longer do large, embarrassed companies look to their extant shareholders for capital infusions. Incompetent managers can be easily replaced without implementing a new capital structure. Disclosure laws and financial analysts ensure that information about firm performance is readily available and disseminated quickly. Many of the salutary aspects of the equity receivership have become standard fea-

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[40] On the general virtues of simple rules, see Richard Epstein, Simple Rules for a Complex World (Harvard 199-).

[41] See Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637 (1973); Robert C. Merton, The Relationship Between

tures of corporate law. Relative priority is not necessary to ensure the survival of large, publicly held corporations.

When all the investment contracts are publicly traded, however, the need for having a reorganization process at all largely disappears.[42] A Chapter 7 liquidation in which there is an actual sale of the firm seems as simple. Indeed, the analogy to the real estate foreclosure becomes compelling precisely because an outright sale of all the assets of the firm to a third party is feasible. The assets of the firm are reduced to cash, which is then distributed, according to contractual priority, to the firm's erstwhile owners. All control rights are removed from the old investors and transferred to the buyer. The buyer, presumably, has decided which capital structure to impose on the firm in advance of making its bid.

The issue of what to do with the firm's managers remains. This problem, however, has little to do with the firm's optimal capital structure. Today's manager of a large, publicly held corporation receives compensation through stock and stock options. But the share of the equity these managers hold is small. Even if creditors decide to retain managers, they have to write new employment contracts. These

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Put and Call Option Prices: Comment, 28 J. Fin. 183 (1973); Robert C. Merton, Theory of Rational Option Pricing, 4 Bell J. Econ. & Mgmt. Sci. 141 (1973).

[42] See Baird, supra note 2.

contracts will cede a small part of the new equity to managers.[43] Indeed, bidders may well approach managers in advance of a bid to ensure their continued availability. To the extent that managers will retain an interest in the firm, this interest will be part of the capital structure imposed by the winning bidder.

There seems to be little reason for departing from absolute priority in modern publicly traded firms, yet there may be little cost to departing from absolute priority in this environment. Stated differently, for the vast majority of investors, investors with diversified portfolios and who contribute no firm-specific skills, the distributional rule may not matter one way or the other. In a world with functioning capital markets and clear legal rules, the most important criteria may be cost of the procedure rather than the distributional rule.[44] A quick auction may be the best alternative.

Even though the equity receiverships involved large firms, the compelling case for absolute priority rule cannot be made for the railroads of a hundred years

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[43] Granting options to managers while a large firm is reorganizing in Chapter 11 is common. See Stuart C. Gilson & Michael R. Vetsuypens, CEO Compensation in Financially Distressed Firms: An Empirical Analysis, 48 J. Fin. 425, 456 (1993).

[44] These include both the direct and indirect costs. The direct costs of Chapter 11 amount to about 3% of asset value. See Lawrence A. Weiss, Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims, 27 J. Fin. Econ. 285, 290 (1990). Total costs of financial distress for large firms seem to lie in the range of 10% to 20% of asset value. Gregor Andrade & Steven N. Kaplan, How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed, 53 J. Fin. 1443 (1998); Edward I. Altman, A Further Empirical Investigation of the Bankruptcy Cost Question, 39 J. Fin. 1067 (1984).

ago as easily, and it should not be surprising that investment bankers, looking out for the interests of the bondholders, crafted a different regime. First, capital structures did not have the clean, neatly hierarchical shape that we see in large publicly traded firms today. Establishing a rule of absolute priority would do little to sort out the respective rights of the creditors. The analogy with the real estate foreclosure as also harder to make. Capital markets of the day were sufficiently primitive that it may not have been easy for third parties to assemble the tens or hundreds of millions of dollars needed to make competing bids for the firm as a going concern. Indeed, attempts by firms in receivership to raise cash from outside investors were, by and large, unsuccessful.[45]

The lack of sophisticated financial markets contributed to the development of the equity receiverships in a second way as well. Railroads that were reorganized often needed a cash infusion. As a practical matter, the only source of this cash was the shareholders. All agreed that the shareholders could receive shares worth what they contributed to the new entity.[46] The proponents of relative priority, however, believed that shareholders had to receive shares more than they contributed in order to induce them to contribute in the first instance.[47] Attempts to raise capital

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[45] See Dagget, *supra*, note --, at 355.

[46] See Baird and Rasmussen, *supra* note --.

[47] See Swaine, supra note 18, at 912-23.

from outside investors as opposed to shareholders met with, at best, mixed success.[48]

Finally, and most importantly, the railroads emerged before the era of professional managers who owned only a small portion of the firm's equity and whose compensation package could be adjusted independently of those of the shareholders. By the time that railroads and other large corporations were run by professional managers as opposed to entrepenuers,[49] the equity receivership had cemented itself as the mechanism by which large firms were reorganized. For the largest firms, equity was increasingly publicly held as well and professional managers replaced the equityholders as the key decisionmakers.[50] The separation of owners and managers that Berle and Means identified as a problem for firms that were not in financial distress made the choice of reorganization regime less important for firms that were in financial distress. Because the managers were distinct from the equityholders, the

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[48] See Ripley, at 396 ("Experience, on the whole, tends to show that the main reliance must be upon the existing security holders; inasmuch as outside offerings for cash to the general public must be at ruinous discounts as to preclude their use.").

[49] Berle and Means report that in 1922, of 44 railroads studied, management held 1.2% of the common stock and .1% of the preferred stock. Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 51 (1932). Despite widespread public holding, however, the control rested with insiders, sometimes through minority blocks, sometimes through pyramid arrangements. See id. at 95-111.

[50] See Berle & Means, supra note 32.

problem of shaping their contracts was distinct from the question of deciding on the capital structure of the firm.

The appropriateness of the absolute priority paradigm for the closely held firm is less clear. To be sure, a considerable number of closely held firms have only a single institutional lender in their capital structures and that lender is owed more than the firm is worth. In such cases, there is no collective action problem to justify a reorganization process at all.[51] To the extent that a relative priority contract best is the efficient one, it will be followed. So long as the lender has the ability to call its loan and initiate a liquidation of the firm in which the manager losses her control rights, the formal priority regime may not matter. When the manager adds value, she will stay; when she does not, she will go.

In other cases, however, where a collective action problem does exist, we may again see a capital structure that is quite different from what one sees in text-books. Lessors commonly make firm-specific investments in the real property on which a retailer conducts its operations. Suppliers issue trade credit and sometimes provide equipment. Buyers may advance part of the purchase price. Relatives of the owner-manager may make loans to the firm, especially when it is in financial dis-tress. Senior managers may defer salaries. If it is engaged with a joint venture with

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[51] At most one may need a procedure to stay the collection efforts of oddball, general creditors while the institutional lender and the debtor decide the fate of the firm. See Douglas G. Baird & Randal C. Picker, A Simple Noncooperative Bargaining Model of Corporate Reorganizations, 20 J. Legal Stud. 311 (1991).

another firm, that firm may have provided equipment or capital. Where the value of the firm as a going concern is plausibly less than what the secured institutional creditor is owed, there is once again a diversity of creditors whose priority rights are hard to sort out.

As in the case of the railroads, the shareholder-managers are needed to ensure that the reorganization takes place. Instead of a deficiency in the capital markets, the inability to separate the firms from the managers who run them itself makes it harder to auction the firms off as going concerns. When a sale of the going concern is not feasible, the analogy between the reorganization and the foreclosure sale is again less compelling. In such an environment, the choice between reorganization regimes (and in particular whether the reorganization should be a recognition event for shareholders) must derive from a theory of capital structure.

III. Reorganization Regimes and Theories of Capital Structure

A. Priority Rules and the Capital Structure Puzzle

In a world in which the Modigliani and Miller propositions hold,[52] it makes no difference that, instead of absolute priority or some other "me-first" rule, we

[52] Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporate Finance and the Theory of Investment, 48 Am. Econ. Rev. 261 (1958).

have a relative priority rule.[53] The overall value of the firm remains constant. In such a world, priority schemes that lessen the value of debt increase the value of equity. As is commonly noted,[54] a theory of capital structure is required before we can make sense of a corporate reorganization regime.

There are, of course, reasons to think that we should treat a corporate restructuring as a recognition event. Financial distress may provide a signal about managerial performance. Let us assume that a risk-neutral entrepreneur seeks funding for a project from outside investors. The project will have a good or a bad outcome. Success depends in part (but only in part) on the efforts of the Entrepreneur. The outside investors are not able to control or observe Entrepreneur's decisions. Under these assumptions, the outside investors might want an investment contract in which they enjoy priority over Entrepreneur. In order to ensure that Entrepreneur has the right set of incentives, she has to take the biggest possible hit in the event of a bad outcome.

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[53] See Eugene F. Fama, The Effects of a Firm's Investment and Financing Decisions on the Welfare of its Security Holders, 68 Am. Econ. Rev. 272 (1978). It is an unfortunate accident that economists returned to the study of corporate reorganizations in earnest when this point was not clear. See, e.g., Jerold B. Warner, Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims, 4 J. Fin. Econ. 239 (1977).

[54] Alan Schwartz, The Absolute Priority Rule and the Firm's Investment Policy, 72 Wash. U. L. Quarterly 1213, 1224-25 (1994) ([T]he optimal bankruptcy scheme cannot be determined independently of the determination of the optimal investment contract.)

Relative priority increases the cost of debt financing. To the extent that Entrepreneur still receives a payoff of some sort in a bad state of the world, the outside investors have to receive an even larger share in the goods states. At the margin, a rule in which Entrepreneur enjoys any payoffs in a bad state of the world is one in which some positive net-present-value projects will not be funded. Under these assumptions, Entrepreneur will seek funding in the form of debt. She will be able to raise the most money at the lowest cost if she can grant an absolute priority debt contract.[55] Of course, this assumes that the value of the project in the bad state of the world is independent of continued managerial effort, a theme that we pick up shortly.

We can see how the absolute priority rule increases the value of the debt contract (and brings about a corresponding decrease in the value of the equity) by returning to the ambiguous investment contract set out in Part II. Investor will part with $125 for the contract that treats the restructuring at t=2 as a recognition event. There is a 50-50 chance that we shall be in the good state, in which case Investor is repaid $150 with certainty. There is a 50-50 chance that we shall be in a bad state. When a reorganization is a recognition event, future values are collapsed to the present. In such a reorganization, Investor receives the entire value of Firm. In expec-

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[55] See Schwartz, supra note 37, at 1225 ("A bankruptcy scheme that encourages deviations from absolute priority reduces the assets that a firm can devote to investors in the failure state, and thus lessens the firm's ability to make a credible

tation, Firm is worth only $100 (one-third chance of $300 and two-thirds of $0). The average of the two is $125. By contrast, if a reorganization is not a recognition event, Investor will part with only $100 for the same contract. Investor still receives $150 if things turn out well in the initial period, but it owns only half of the equity in Firm when the firm fares poorly. It will receive $150 one-third of the time and nothing the rest. Hence, in bad states, its interest is worth $50. The average of $150 and $50 is $100.

This familiar model of the firm suggests that we should treat the reorganization as a day of reckoning and then use absolute priority as a starting point. To be sure, the absolute priority rule is not optimal. Given the assumption that the outside investors cannot observe or control what the entrepreneur does, the absolute priority contract might lead the entrepreneur to entrench herself.[56] Such entrenchment increases the entrepreneur's value to the firm, which, in turn, will increase her bargaining position in the case of a reorganization. Absolute priority might also lead her to postpone the reorganization past the optimal time.[57] When the prospect of a bad outcome begins to loom large, the entrepreneur may have insufficient incentive

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repayment promise. Thus, such a scheme would not, ceteris paribus, be part of an optimal debt contract.")

[56] See, e.g., Lucian A. Bebchuk & Randal C. Picker, Bankruptcy Rules, Managerial Entrenchment and Firm-Specific Capital (University of Chicago, Law and Economics Working Paper No. 16, 2d Series, 1993).

[57] See, e.g., Douglas G. Baird, The Initiation Problem in Bankruptcy, 11 Intern'l Rev. L. & Econ. 223 (1991); Paul Povel, Optimal "Soft" or "Tough" Bankruptcy Procedures, 15 J. L. & Econ. Org. 659 (1999).

to take steps that have a net positive present value.[58] Conversely, absolute priority may induce managers of an insolvent to take even riskier projects with net negative present values, as they do not bear the downside in the case of failure. Nevertheless, these qualifications do not keep the absolute priority rule from being a sensible baseline.

This model, however, does not confront the question of how the firm operates after the reorganization is over. Put differently, the model assumes that the event that triggers the reorganization is the same event that triggers the provisions in the manager's contract designed to confront the moral hazard problem. This assumption is a natural one if the firm is to be liquidated or sold to a third party. It is also reasonable if the managers have no firm-specific expertise and anyone else can run the business as well. Moreover, the assumption works if financial distress is a strong proxy for managerial misperformance.[59] But these conditions do not necessarily hold.[60] Put simply, the above model assumes that the value of the firm after

[58] See, e.g., Robert K. Rasmussen, The Ex Ante Effects of Bankruptcy Reform on Investment Incentives, 72 Wash. U. L.Q. 1159 (1994).

[59] Financial distress is a proxy for managerial misperformance only if one makes certain assumptions about capital structures. The relevant question is whether some other mechanism is a better proxy. After all, managers often are terminated even where no bankruptcy petition is filed.

[60] There is, of course, empirical evidence suggesting that the two are in fact related. Managers of firms that encounter financial distress take a financial hit. In the case of publicly traded firms in this country, the income of the chief executive officer falls when the firm encounters financial distress. See Gilson & Vetsuypens, supra note 30, at 456. In the case of closely held firms in Sweden, compensation also

reorganization is independent of the continued effort of the manager. Hence, we can plausibly construct a moral-hazard model that leads us to a radically different regime.

Firm is founded at *t*=1 with a capital investment from Investor of $30. Manager is hired to run the firm in return for equity in the firm. Firm is to be liquidated at *t*=3. At *t*=3, Firm will be worth $100 with 75% probability if Manager dedicates herself mind, body, and soul to the enterprise between *t*=2 and *t*=3. If she does not work hard then, it will be worth $100 with only 25% probability. If Firm fails, it will be worth nothing at *t*=3. Hard work costs Manager $20.

Once Manager agrees to work for Firm, she has no ability to earn money elsewhere until after *t*=3. At *t*=1, there is a competitive market for such managers. They are entirely fungible. Managers are risk-neutral, but there is no way to tell whether they work hard or not. At *t*=1, Investor creates a capital structure in which she takes a note for $60 and Manager receives 100% of the equity. Manager works hard because her expected return from working hard is $30. (She has a 75% chance

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falls, regardless of whether the CEO remains with the firm or goes elsewhere. See Karin S. Thorburn, Auction Bankruptcy and the CEO, Conference on Contemporary Corporate Governance Issues (Tuck School of Business, July 2000). Such evidence suggests that managers are responsible in significant measure for the financial distress in which the firm finds itself. But what is true as a general matter is not true in all classes of cases. Moreover, we should be careful not to draw too much from this evidence. If managers must renegotiate their contracts in the event of a reorganization, the creditors have a chance to capture some of the firm-specific investment that the managers have made in the firm. Similarly, when they go to work else-

of getting $40 ($100 minus the $60 paid to Investor in good states of the world.) This is worth $20 more than what Manager expects to receive if she shirks. (If she shirks, she has a 25% chance of getting $40.)

At *t*=2, a new and entirely unexpected government regulation is passed that requires that Firm invest $30 in new equipment. If the equipment is installed, Firm still is worth $100 with 75% probability (assuming Manager works hard) at *t*=3. If the equipment is not installed, however, Firm must be shut down at *t*=2 and it will be worthless.[61]

Firm is worth keeping intact as a going concern. If Manager works hard, Firm still has an expected value of $75 after the equipment is installed and the new equipment costs only $30 and Manager's hard work costs only $20. Hence, the sensible course is to install the equipment. Firm must find a new source of capital because Investor will not make any additional contributions. Investor approaches Financier. Financier agrees to contribute $30 in return for a note for $40. (If Manager works hard, Financier will receive $40 with 75% probability, giving her an expected return of $30.) Financier, however, insists that Firm's capital structure be changed. Financier will not lend unless Firm will be solvent at t=3. It will agree to loan $30 in

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where, they cannot exploit the firm-specific skills they acquired while at the previous firm.

[61] Of course, any exogenous shock outside the control of Manager would do as well for our purposes.

exchange for a $40 note only if Firm can pay its debts in full and only if Manager retains the incentive to work hard.

If the parties had anticipated this contingency at the time of the original bargain, they would have provided that under these circumstances Investor would write down her own note to $20 and Manager still retains all the equity of the firm. Reorganization cannot be a recognition event for Manager. She needs to retain the same equity interest after reorganization that she had prior to reorganization in order to ensure that she works hard. The government requirement does not change matters. Firm needs a new capital structure because of its need to raise money to pay for the equipment. But the need for the new capital has nothing to do with Manager. The optimal contract before the exogenous shock was one that gave Manager 40% of the value of Firm at t=3. Only with such a contract will Manager work hard. If Manager has the optimal contract at the time of a restructuring and if the restructuring itself is not connected with Manager's performance, then that contract should not change in the wake of the restructuring.[62]

B. Relative Priority and Los Angeles Shipbuilding

The circumstances in which it made sense to have a reorganization regime that does not work as a recognition event for the shareholders can be gleaned from

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[62] In the context of the equity receivership of railroads, Manager played the role of financier. Thus, Manager would receive new stock the value of which was in excess of what she paid for it.

the last case in which the relative priority rule was applied. The Los Angeles Shipbuilding & Drydock Corporation was a shipyard that built ships for the Navy during World War I. The only creditors of the firm held long-term bonds due in 1944. The shipyard languished during the isolationism of the 1920s however, and by 1930 the shipyard could no longer meet its interest payments. There was a restructuring of the debt outside of bankruptcy in which interest was to be paid only as earned. The shipyard continued to struggle during the 1930s. Military spending slowly began to increase and the shipyard was one of the few firms with the expertise to win lucrative government contracts, but it also needed substantial capital investments to be competitive.[63]

Given the slow rate of increase in government spending, the shipyard in all likelihood would not be able to pay the bondholders in full. The old bondholders were not willing to make any additional investments and outside investors were unwilling to lend money to a firm that was insolvent. The firm was not in default to its bondholders and, given the terms of the workout, could not be until the bonds became due in 1944. Outside investors, however, did not want to lend in an environment in which the firm would likely default to its other creditors.

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[63]The facts are set out in In re Los Angeles Lumber Products Co., 24 F. Supp. 501, 513 (S.D. Calif. 1938), affirmed, 100 F.2d 963 (9th Cir.), reversed, 308 U.S. 106 (1939). Further background on the case can also be found in 2 Arthur Stone Dewing, The Financial Policy of Corporations 1309 (5th ed. 1953).

The bondholders of Los Angeles Shipbuilding would be better off if the firm went through a reorganization. They were better off accepting the reality that the firm, in all likelihood, would not be able to pay them off in full. If they scaled back their claims, the firm would be able to obtain new financing and remain a successful competitor in its industry. If the creditors refused to scale back their claims, the firm would, at best, limp along and they would be even worse off by the time their bonds became due. They would have a larger share of a much smaller company.

The shipyard had value as a going concern. It had large machinery and equipment that was geared to the building of ships for the Navy. Moreover, the manager-shareholders had the contacts in the Navy and the technical expertise to build the kind of ships that the yard was designed to build. This firm was the prototypical example of a firm that needed to be reorganized. This firm, however, also illustrates one of the significant costs of treating a reorganization as a day of reckoning for the shareholders.

If the shipyard failed to obtain new funding, it would likely limp along until 1944. At that point, the firm would likely be liquidated and the shareholders would receive nothing. But it was also possible that events might come along (such as a world war on a scale never experienced before) that would allow even an outdated shipyard to flourish. In such an event, the shareholders would receive something. This possibility took away any incentive the shareholders would have to bring about a reorganization in 1936 if the reorganization wiped out their interests as it

would in a regime of absolute priority. (There was a chance that the firm would do well, but the odds were that it would not.)

The shipyard found itself in financial distress for reasons wholly unconnected with the performance of the managers. Their current contract ensured that they would devote themselves to the firm and, at the margin, do the best they can, given the circumstances in which the firm finds itself. The day of reckoning is sufficiently distant that the managers will not take short-term risks at the expense of long-term gains. The restructuring that must take place in 1937 is the result of bad performance by the managers, but rather is necessitated by the wholly exogenous events that gave rise to the need for new capital equipment. Nothing about the restructuring suggests that anything was amiss with the deal that was cut with the managers in the restructuring that took place in 1930.

In this context, it makes little sense to have a restructuring regime that requires wiping out the interests of the shareholders. First, the managers themselves are the ones that understand the business and understand the need for new financing. The bondholders are scattered all across the country. None of them knows that the reorganization is necessary nor do they possess any of the skills needed to carry it off. Indeed, part of the value of the firm rests on the knowledge of the managers about potential sources of new capital. Even if the outside bondholders had the knowledge and skill necessary to reorganize the corporation and find new funds, they lack any means of bringing it about, as the firm is not in default on any of the

bonds and will not be until 1944. The managers for their part have no reason to restructure the firm if a restructuring leaves them with nothing.

But let us assume that the creditors are able to work together. They can monitor the firm and can land the new financing. Even under these assumptions, the creditors still have to contend with the bad incentives that the prospect of the reorganization brings. Such a reorganization regime is one in which the time horizon of the managers is dramatically shortened. Instead of making decisions that maximizes the value of their equity interest almost a decade hence, they make decisions that maximize the value of that interest over the very short term. They do not make investments whose payoff will not make the firm solvent over the short-term. They make decisions that make them indispensable if the firm is reorganized and they conceal information about the need for the reorganization.

Even if none of these concerns matter, after the reorganization takes place, the creditors still need to find someone to run the firm. The managers, with their firm-specific capital, are the best people to do it. Moreover, to ensure their incentives are correctly aligned, whoever runs the firm needs to be given equity. The value of the equity they need to have, the amount needed to give them the right set of incentives, is equal in value to the equity interest of the firm that the existing managers needed to have after the workout in 1930. In other words, assuming that their management contract was correctly written in 1930, the creditors have to enter

into the same contract with the same managers again in a world in which the reorganization is a day of reckoning.

This example captures in a nutshell a fundamental weakness in treating a reorganization as a recognition event. Sudden discontinuities by their nature introduce bad incentives. Under the facts of the shipyard case as presented here, a more sensible legal regime is one in which the reorganization leaves unaffected the *value* of the manager's equity interest. If the bondholders need the managers to run the firm after the reorganization and if they are not overpaying them now, it makes no sense to have a reorganization regime that terminates the interests of managers, and forces creditors to enter into post-reorganization negotiations that will produce the same contract. As long as the managers are not responsible for the events that gave rise to the reorganization, the reorganization should leave the value of their compensation unaffected.

Moreover, a reorganization regime that leaves the value of their interests unaffected creates no discontinuities. They have no reason to postpone the reorganization and no reason to take short-term gambles. The under- and overinvestment problems are created by the day of reckoning itself, not the distributional rule employed on the day of reckoning. The new capital structure does have some effects on the managers. These, however, are largely positive. Because the firm is once again solvent, the risk that the managers will take long-shot gambles is, for example, significantly diminished. In competing for Navy contracts, for example, the

managers are less tempted to bid for the contracts that are more lucrative, but even harder to land. Nor do the managers have any need to entrench themselves, as they face no round of bargaining after the reorganization to renegotiate their contract.

The plan of reorganization in *Los Angeles Shipbuilding* attracted only two dissenting votes among the many diverse bondholders. One of them had made a career of buying distressed bonds and holding up other creditors for the full amount of his bond by threatening to force a liquidation of the firm if they did not capitulate. Workers at the shipyard passed the hat among themselves to raise the money to pay him off.

In the *Los Angeles Shipbuilding* case, there was a concrete way to frame the inquiry into the value on the old shareholders' equity interest that the reorganization should leave untouched. They should enjoy an interest in the reorganized firm equal in value to the cost of an option to buy the shipyard in 1944 for the amount owed to the bondholders. Ordinary firms do not have a definite terminal date that provides the benchmark for the valuation of the equity interest, and one must approximate the likelihood that the firm would encounter a liquidation, third-party sale, or other event that would serve as a recognition event. This probability is then used to calculate the option value of the equityholders' interest in the firm.

During the period before 1940, courts usually managed to avoid such questions. Not only were the precise contours of the law unclear,[64] but the procedure in place often relieved the court of making such hard decisions. By the time the question was ripe, it was rarely in the interest of anyone to press the point. No court ever used the words "absolute priority" or "relative priority" until 1939. In many cases, the court could leave unresolved even the question of whether the firm being reorganized was solvent. A reintroduction of relative priority in any process like modern Chapter 11, however, would not allow such an easy escape. Valuation questions are now front stage and center and the use of markets to test valuations has become the norm.[65]

IV. Priority Rights and Control Rights

It is one thing to conceptualize a relative priority contract; it is another to write one. Even in a two-party negotiation, setting the appropriate option value of a manager/shareholder's interest at some undetermined time in the future seems a

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[64] Much of the ambiguity was generated by the Supreme Court. In Kansas City Terminal Railway v. Central Union Trust, 271 U.S. 445 (1926), the Court found that a reorganization had to recognize the right of all creditors "to be preferred to stockholders against the full value of all property belonging to the debtor corporation." 271 U.S. at 454. The opinion does not discuss what it means by "full value." As Swaine pointed out, this observation is as consistent with a regime of relative priority as with absolute priority. See Swaine, supra note 4.

daunting task. The task becomes insurmountable once we recognize that many privately held firms have numerous creditors. Relative priority contracts are, by their nature, incomplete. Indeed, it is this very incompleteness that allowed reorganizers to commandeer the equity receivership when the railroads ran into financial distress. To make relative priority a useful way to describe capital structures, one needs an institution to implement a relative priority regime. To the extent that one can not write a verifiable relative priority contract ex ante, one needs to craft an environment where reneogtiations of the various interests will lead to managers retaining the appropriate interest in the reorganized firm. We now look at the lineal descendant of the equity receivership, Chapter 11.

Debates in Chapter 11 have centered over priority rights. Investment contracts, however, are as much about control rights as about priority rights. J.P. Morgan and his cronies had the freedom to craft solutions designed to best protect the various investors in the railroads. Not only did they impose a new capital structure on the insolvent railroad, but they ensured that they had unfettered control of the railroad for the period immediately following the reorganization. Through the voting trust, they in effect had a real option on the future services of managers. If the managers performed well, they could stay, if they did not they

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[65] See, e.g., Bank of America National Trust Savings Association v. 203 North LaSalle Street Partnership, 526 U.S. 434 (1999).

could go. Also, to the extent that the railroad needed to be merged with another entity, the voting trust gave the investment banker the power to effect the merger.

The modern day analog is the venture capitalist. Today's venture capitalists enjoy an environment in which the parties are free to enter into whatever contracts they want.[66] From these contracts, we can see that control rights are all-important in bad states of the world. Those who control a firm in bad states of the world must make three decisions: They must decide: (1) whether to continue the firm or shut it down; (2) whether, if the firm continues, to retain current management; and (3) how, if the managers are kept, to compensate them. A theory of corporate reorganizations centered on absolute priority addresses only the last two and then only imperfectly.

These shortcomings can be tied to history. During the era of the equity receivership, the decision whether to keep the firm intact was usually trivial. The railroad was almost always worth keeping as a going concern, even if some lines and spurs might have to be abandoned. The second issue was of significant moment in equity receiverships. Managers were occasionally corrupt. More often they were inept. Those who controlled the reorganization had the power to get rid of them and did so as the need arose. But this happened during the reorganization and outside the context of a plan. By putting the stock of the reorganized railroad in a

voting trust for up to a five year period, reorganizers were able to keep a firm hand on management as the railroad attempted to operate under its new capital structure. This control, in effect, gave the investment bankers a real option on the services of the managers. They did not have to make an irrevocable decision to retain managers during the course of the reorganization itself. With respect to the third issue, the problem was largely mechanical after making the decision to keep the managers. One had to estimate the amount of new capital the firm needed and then calculate the additional equity interest needed to ensure that the manager's incentives were properly aligned going forward.

Although nominally a regime of absolute priority, Chapter 11 works in a limited way as the equity receivership with respect to the last two questions. The creditors as a group do not have to continue the current managers or allow them to retain their equity interests. Nevertheless, when the firm is worth keeping intact as a going concern and the managers themselves are able, it is in the interests of the creditors as a group to allow them to keep their equity interests. Between 1940 and 1978, the law gave each creditor the right to invoke the absolute priority rule, while under current law the absolute priority rule comes into play only when a class re-

[66] Venture capitalists take their interest in the form of preferred stock and other similar instruments, rather than debt. When a firm has no debt, it is not eligible for bankruptcy and hence Chapter 11's mandatory rules never apply.

jects a confirmation plan.[67] Before 1978, individual creditors could (as we saw in *Los Angeles Shipbuilding*) profit by holding out. When each creditor is bound by a majority vote, however, it is in their individual interests to vote in favor of a plan that maximizes the value of the firm. Creditors of closely held firms have no interest in holding equity and understand that it belongs in the hands of whoever is managing it. The departures from absolute priority that we see in such cases may reflect the creditors' recognition that relative priority is in their own self-interest. In Chapter 11, creditors as a group may able to implement a relative priority regime because Chapter 11's majority-voting rules eliminate the hold-out problem. The transactions-cost barrier that existed under old law has been lowered significantly. No longer do workers have to pass the hat to pay off the stray recalcitrant creditor.

A relative priority regime, however, assumes that firms that are being reorganized are worth keeping intact as going concerns. To assign interests in a reorganized firm, one needs a reorganized firm. Chapter 11, however, slights this issue. Creditors have too little power over the threshold question of whether the firm continues as a going concern at all. Ordinary mechanisms of corporate governance are suspended. Creditors, even as a group, cannot liquidate the firm on their own initiative. Nor can they oust the managers immediately based on their belief that

[67] Current law accords individual creditors the right to insist that they receive what they would have in a piecemeal liquidation of the firm. This right tracks the right of dissenting creditors in an equity receivership to claim its share of the amount bid at foreclosure.

the managers need to go. Managers are given agenda setting authority and they can, with the assistance of a compliant bankruptcy judge, ensure that a plan of liquidation never gets on the table. Managers can use the power given to them to extract concessions from the creditors. Creditors, in effect, have to buy off the procedural protections given to managers.[68]

A decision that ordinarily resides with a venture capitalist resides with a bankruptcy judge inside of Chapter 11.[69] In the case of the railroads, there was typically little doubt that they were worth keeping intact as going concerns. By contrast, many modern firms in financial distress have no firm-specific assets. There are few costs associated with treating the reorganization as a recognition event or indeed selling the firm's assets off piecemeal. Even if the managers are able and are not responsible for the financial distress, there is no special virtue in keeping the firm intact.[70] To be sure, this does not describe all firms. However, bankruptcy law, in its

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[68] This having to buy off managers best explains why we often see distribution to shareholders in the reorganization of large, publicly held companies.

[69] See Douglas G. Baird & Edward R. Morrison, Bankruptcy Decisionmaking (University of Chicago Working Paper September 2000).

[70]Chapter 11 is often the forum of choice for sorting out the problems of a failed business that has little value as a going concern. See Samuel L. Bufford, What is Right About Bankruptcy Law and Wrong About its Critics, 72 Wash. U. L.Q. 829 (1994). For example, apart from a secured creditor that may have already repossessed its collateral, the only other creditor in the money may be the IRS, which is owed FICA and withholding taxes. The owner-managers of the business are likely to be personally liable for these taxes. Chapter 11 provides a forum for them to negotiate a settlement. The role that the IRS plays in many small Chapter 11s makes

extant form, provides no mechanism to sort out these firms. There is an incentive compatibility problem. The persons with the best information about the firm's future prospects – its managers – are the ones who suffer the most from termination.[71]

In the case of many closely held firms, there is a large institutional investor that will be able to assess the condition of the firm, know when it needs to be reorganized, and be able to ensure that the managers do not make (or fail to make) major decisions correctly. Major suppliers and the real estate lessor can play a similar role. The ability of an outside creditor to assess accurately the state of the firm reduces the incentive compatibility problem. As with the investment banker in the day of the railroads and the venture capitalist in the case of start-up firms, they may be the ones best positioned to decide whether the firm should continue.

In such a world in which investors can monitor effectively, the problem of how much or in what way the managers should be compensated is tertiary. The first decision is whether the firm, under any circumstances, should be kept up and running. The second decision is ensuring that the firm has the right manager at the right time. In deciding to make an investment initially, one of the most significant factors for the venture capitalist is the strength of the management team. The in-

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inapt many of the conventional analyses of Chapter 11, based as they are notions of the creditors' bargain.

[71] To overcome this incentive compatibility problem, Alan Schwartz proposes a "bribe" where managers are in effect paid to put the firm into liquidation rather than reorganization. See Schwartz, Yale piece. This, in effect, is a version of relative priority for liquidating firms.

vestment contract itself varies depending on the venture capitalist's perception of the strength of the management team. Indeed, the venture capitalist's ex ante assessment of the strength of the management team is still one of the strongest predictors of whether the firm ultimately goes public. The venture capitalist's investment contract ensures that she has the power to replace the managers in bad states of the world. By contrast, the venture capitalist's ability to cut back on the manager's equity interest in bad states of the world is sharply limited. [72]

Any regime in which the reorganization takes time is suspect to the extent that it disables the contractual devices that allow investors to decide whether to keep the firm intact and whether to keep the managers in place. Relative priority and absolute priority regimes both suffer from this deficiency. Any coherent account of corporate reorganizations cannot focus narrowly on priority. We cannot leave unexplored the question of how investors oversee the relationship between the managers and the firm in good times and bad. Allocating priority rights cannot be done independently of control rights. The problem of corporate reorganization is at bottom a problem of corporate governance.[73]

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[72] See Steven N. Kaplan & Per Strömberg, Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts, NBER Working Paper 7660 (April 2000); Steven N. Kaplan & Per Strömberg, How Do Venture Capitalists Choose Investments? (manuscript, University of Chicago September 2000).

[73] To the extent possible, this is a matter best left to private contracting. See Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bank-

ruptcy, 71 Tex. L. Rev. 51 (1992); Alan Schwartz, A Contract Theory Approach to Business Bankruptcy, 107 Yale L.J. 1807 (1998).