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”The End of Bankruptcy” Revisited

Robert Rasmussen*

*University of Southern California, rrasmussen@law.usc.edu

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Abstract

The End of Bankruptcy, published in 2002, set forth a view of corporate bankruptcy based on a theory of the firm. It argued that, for a traditional Chapter 11 proceeding to be necessary, it had to be the case that a firm had going concern surplus, that the firm’s investors cannot realign the capital structure through normal bargaining, and that a going-concern sale is not possible. Changes outside of bankruptcy had made each of these necessary preconditions less common. This chapter revisits this work, and shows that, despite the upheaval of the Great Recession, it remains the case that traditional reorganizations remain rare. Chapter 11 continues to play a role in our modern economy; it is just not the role that its drafters envisioned.

The *End of Bankruptcy* Revisited
Robert K. Rasmussen†

In 2002, Douglas Baird and I published "The End of Bankruptcy."[1] The piece had two main aspirations. The first was to articulate the conditions necessary for a Chapter 11 proceeding to serve its traditional goal of protecting a business's going-concern surplus through a negotiation among its stakeholders; the second was to then use this understanding as a basis to take stock of existing bankruptcy practice, especially as it grappled with the financial distress of large enterprises.[2] Despite the absence of major amendments to Chapter 11, bankruptcy practice had changed in fundamental ways. Chapter 11 proceedings had shifted from their historical use to something quite different. The two points are linked. It is only by articulating how a business can have a going-concern surplus and how such a surplus can be preserved that enables one to provide insight into the forces driving changes in extant Chapter 11 practice, as well as others that were sure to come. In this essay, I want to revisit *The End of Bankruptcy* and take stock of what we have learned, and how bankruptcy practice has continued to evolve in the intervening years.

I. The End of Bankruptcy

The accepted understanding of Chapter 11 of the Bankruptcy Code was that it enhanced social welfare by creating a forum where businesses and their owners could address the challenges of financial distress.[3] Specifically, bankruptcy solved a collection action problem among the firm's creditors. Left to their own devices, the creditors – realizing that there were insufficient assets to satisfy all of the firm's obligations – would tear the firm apart as each sought to get paid in full. Chapter 11 called a halt to these individual collection efforts and replaced them with a forum where the stakeholders of the firm could make decisions collectively. The basic alternatives that they had were either to shut

† J. Thomas McCarthy Trustee Chair in Law and Political Science. My thanks to Barry Adler and Douglas Baird for helpful comments on this chapter.

[1] Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy,* 55 Stan. L. Rev. 752 (2002).

[2] We did, however, offer some thoughts on the reorganization of smaller companies. See *id.* at 788-89.

[3] The best articulation of this justification for Chapter 11 remains Thomas H. Jackson, The Logic and Limits of Bankruptcy Law (1986). See also United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) ("In proceedings under the reorganization provisions of the Bankruptcy Code, a troubled enterprise may be restructured to enable it to operate successfully in the future. Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap.'").

down the business or to revamp the capital structure and possibly the operation of the enterprise. The centerpiece of the proceeding was the negotiations that led to a plan of reorganization. It was through this process that the various stakeholders – the managers, the creditors, the equity holders – decided the future of the business. If the bargaining environment were set up correctly, the governing wisdom was that Chapter 11 could provide value by saving companies that would have otherwise been liquidated.[4]

But what are the principles by which one determines whether any given business that files for Chapter 11 should be reorganized through a negotiation among its various stakeholders? No one thinks that Chapter 11 should offer rehabilitation to every business that files for bankruptcy. Some enterprises should not continue. Moreover, the rise of a robust takeover market for even the largest of businesses meant that a sale of a troubled business was now possible. This burgeoning market for distress businesses meant that a reorganization that struck a deal among the business's extant investors was no longer the only way to prevent a liquidation of the enterprise. In sum, Chapter 11 rested on a theory of valuation preservation without an operative theory as to where that value was coming from.

What the conventional story lacked was a robust theory of the firm.[5] Theories of the firm explain why we see economic activity inside of a firm as opposed to in the market. While economists have wrestled with the question of "why a firm?" for decades, they tend to slight legal boundaries when they describe firms. They focus on functional, rather than legal, demarcations. Bankruptcy law, on the other hand, operates on legal entities.[6] Thus, in moving

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[4] To the extent that there was a disagreement over the normative goals of Chapter 11, it was not a disagreement over whether the proceeding should preserve going-concern surplus via collection action. Rather, it was whether it should do more than this, such as having a bias towards reorganization, see Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C.L. Rev. 129, 149 (2005) ("rehabilitation and reorganization were the policy goals underlying the enactment of the Bankruptcy Code"), or reallocating the losses caused by financial distress, see Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 778 (1987) ("bankruptcy policy becomes a composite of factors that bear on a better answer to the question, 'How shall the losses be distributed?'").
[5] Trying to articulate why a firm exists traces back to Ronald Coase's seminal work, Ronald H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937).
[6] The importance of the legal boundaries inside a business is receiving renewed attention these days, especially in the work of Tony Casey. See Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, 124 Yale L.J. 2680 (2015); Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 Colum. L. Rev. 1 (2013).

from the economic literature to the bankruptcy setting, it is necessary to articulate why the legal entity that is in bankruptcy had value above and beyond the alternative uses for its assets. In short, "[R]eorganization law ought to begin by ascertaining the value of keeping *particular* assets together inside a *given* firm."[7]

Connecting the theory of the firm with corporate reorganization reveals that "[t]he traditional account of corporate reorganization assumes a financially distressed business faces three conditions simultaneously: (1) It has substantial value as a going concern; (2) its investors cannot sort out the financial distress through ordinary bargaining and instead require Chapter 11's collective forum; and (3) the business cannot be readily sold in the market as a going concern."[8] To the extent that any one of these conditions failed to hold for a given entity, it made little sense to resort to Chapter 11's bargaining process. Changes in the marketplace had made it less likely the any, let alone all, of these conditions would obtain for any given firm.

That does not mean that when these three elements were lacking, it did not make strategic sense for a firm to file for bankruptcy. By "End of Bankruptcy" Baird and I did not mean that Chapter 11 would be stricken from the Code or that companies would cease to use its provisions. Quite the contrary; the powers that reside in Chapter 11 to alter relationships among various parties meant that it would still play a role in resolving the problems that arise when a business encounters financial distress. Rather, the essential point is that because of changes in the market and in bankruptcy practice, Chapter 11 would no longer be operating in the fashion intended by those who drafted it.

To see why this is the case, it is helpful to start with the observation that the cost of rearranging the assets in the market place places an upper limit on the value of the corporation. If the assets can be easily and cheaply reassembled outside of bankruptcy, the value that bankruptcy can save is only the cost of putting together the new operation. Thus, any role for corporate reorganization to play requires that the firm have a going-concern surplus, as defined by the inability to recreate the enterprise at a cost that is less than the cost of a bankruptcy proceeding. A necessary implication of this observation is that as transaction costs decline, and it becomes easier and cheaper to reassemble assets outside of bankruptcy, the value of the bankruptcy proceeding declines as well.

[7] Baird & Rasmussen, *supra* note 1 at 758.

[8] Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673, 673-74 (2003).

Even if a business has going concern value, the case for addressing the business's financial distress through a Chapter 11 proceeding remains incomplete. A going concern surplus is a necessary but not sufficient condition for a traditional Chapter 11 reorganization. By definition, bankruptcy is only a possibility when a business is experiencing financial distress that cannot be otherwise resolved. Traditional accounts of Chapter 11 assume that the disparate owners of the company cannot work together outside of a bankruptcy proceeding to solve the problem of financial distress. Indeed, it is the fear that the owners will rush to dismember the business that is the canonical justification behind Chapter 11. Put differently, control rights are not parceled out in a coherent manner.[9] To the extent that control rights are assigned sensibly such that they adjust as the financial condition of the business deteriorates, there is less work for bankruptcy law to do.

Current law places some impediments in the way of ensuring that a business's control rights and capital structure can be adjusted outside of bankruptcy. Even if the firm's creditors could come to agreement amongst themselves and with the debtor as to a new capital structure, such an agreement would be difficult to implement without a bankruptcy proceeding. The Trust Indenture Act prohibits changing the basic terms of a debt holder's financial instrument without that party's consent. For firms that have issued public debt, the free-rider problems created by this prohibition stand in the way of efforts to resolve the debtor's financial distress.[10] The collective forum is needed because there is no way to effectuate the value-enhancing agreement outside of bankruptcy.[11]

Finally, even if a firm has going-concern value, and even if its owners cannot strike a deal amongst themselves outside of bankruptcy to resolve the problem of financial distress, the traditional account of Chapter 11 only makes sense if a market sale is not an option. A market sale both provides a valuation of the company and vests control rights over the business in the buyer. A

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[9] On the need to focus on control rights in articulating the role that bankruptcy law plays, see Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 Va. L. Rev. 921 (2001). For an early recognition of the way in which adroit assignment of control can lessen the need for a Chapter 11 reorganization, see Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. Rev. 343, 345, 367-75 (1997).
[10] See Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232 (1987).
[11] To the extent that the Trust Indenture Act prevents terms such as collective action clauses, it should be repealed. In the area of sovereign distress, where the Trust Indenture Act does not apply, it is now common for countries to issue bonds that contain collective action clauses. See Mitu Gulati & Mark C. Weidemaier, *A People's History of Collective Action Clauses*, 54 Va. J. Int'l L. 1 (2014).

traditional Chapter 11 proceeding, in contrast, requires the valuation of the enterprise and a negotiation over how control rights are going to be assigned over the reorganized entity. In deciding who owns what in the new company, the parties have to agree on the value of the company. Assigning a value is a time consuming process, and an inaccurate one at that. That valuation process then affects how control over the business is going to be parceled out. Thus, as a matter of procedure, a sale may be cheaper than a negotiated reorganization.[12]

The poster child for reorganization law has always been the railroad.[13] It is the paradigmatic case where the conditions necessary for a reorganization existed. Indeed, the history of our law of corporate reorganizations is tied up in the history of the railroads. The railroads were the first major American corporations. In laying down track, the company building the road would often underestimate the cost of construction. New rounds of financing would be needed to continue construction, with the company returning again and again to the debt markets. This method of building coupled with repeated borrowings often created a situation where the railroad was hopelessly insolvent. The railroad could never hope to generate enough revenue to pay off the debt that it accumulated in building the road. Yet, on an operating basis, the railroad was making money; its current revenues exceeded its current expenses. Finally, the relationships among the various bondholders was such that each group of bondholders had its own separate collateral, but each piece of collateral was worth little unless it was combined with the collateral that was owned by the other bondholders.

It was in this environment that the American law of corporate reorganization took root. There are very few alternative uses for railroad track. You can run a railroad over it if it is profitable to do so, or you could turn it into scrap. There is little else in between. For roads that generated current revenue in excess of current expense, it made little sense to shut them down. The railroad, albeit insolvent, had a substantial going-concern surplus.

This surplus, however, could not be captured through negotiation amongst the various bondholders. The problem was reaching agreement both among those who held a given issue of bonds and between the various groups of bondholders. The bondholders themselves were dispersed, living both in the

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12 As Baird has pointed out, the need for a valuation in the negotiation context is a consequence of respecting absolute priority. A system that embraced relative priority could engineer a reorganization without having to value the business as a whole. See Douglas G. Baird, *Priority Matters*, 165 Pa. L. Rev. (2016) (forthcoming).

13 See David A. Skeel, Jr., Debt's Dominion 48-70 (2001); Baird & Rasmussen, *Control Rights*, *supra* note __ at 925-936.

United States and Europe, and there was no procedure in place that would allow the bondholders to work together. Moreover, a sale of the road was impossible. The value of the railroads exceeded what the capital markets at that time could hope to raise.

For those roads that were cash flow positive but insolvent, the only choice was to revamp the capital structure. The dedicated assets, the lack of a coherent capital structure and the lack of a market alternative required that the financial distress of railroads be handled in a negotiation among the various investors. Reorganization lawyers grabbed ahold of the equity receivership, and modified it so as to provide a forum in which the various owners of the railroad could hammer out a new capital structure.[14]

While corporate reorganization grew out of the financial distress of the railroads, it is often overlooked that the railroads were, even at the time, an unusual case. Most businesses do not rely on assets that only have value to that that operation. Indeed, even in industries where specialized assets were important, they often moved among different businesses within the industry. This is especially true of human capital and intangible assets. If anything, these trends have accelerated in the modern economy.

Understanding the theory of the firm on which bankruptcy rests helps to explain the fundamental changes that occurred in the practice of bankruptcy law, especially as it affected the reorganization of large companies. To understand the magnitude of these changes, it is helpful to recall the academic understanding of Chapter 11 at the start of the twenty-first century.

Chapter 11 of the Bankruptcy Code replaced Chapter XI of the Bankruptcy Act in 1979. The first years of the new provision's operation alarmed many. There were concerns that the debtor's old management remained in control of the firm; that they (and shareholders as well as unsecured creditors who were out of the money) had a bias towards continuing the business basically in its current form in hopes for a turnaround in the debtor's fortunes; and that money was being extracted from senior lenders to pay for this effort. The fear was that good money was going to be thrown after bad in a search for a turnaround that

[14] In this bargaining environment, the deal that was struck tended to follow relative priority. See Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost,* 1999 S. Ct. Rev. 393, 401-08. It was Justice Douglas who later enshrined absolute priority into the law of corporate reorganizations. See Robert K. Rasmussen, *The Story of Case v. Los Angeles Lumber Products: Old Equity Holders and the Reorganized Corporation*, in Bankruptcy Law Stories (2007).

would never come. In short, asset allocation decisions were being poorly made.[15] On top of this, the priority of claims established outside of bankruptcy was not being respected.[16] Despite the Bankruptcy Code's commitment to absolute priority, equity holders were able to secure part of the reorganized company for themselves, often at the expense of senior lenders.[17] While the actual violations of absolute priority were modest, the direct and indirect costs of negotiating over the fate of the business loomed large. The reason for these problems lay in the fact that the Code gave substantial power to the managers of the corporation, and they could use that power to keep creditors at bay. Lenders confronted with this state of affairs had to contribute to the reorganization efforts, basically buying off the hold up power given to the debtor.[18]

Things had change dramatically by 2000. Two trends stood out. The first was the increasing use of prearranged bankruptcies. As noted earlier, the Trust Indenture Act makes out-of-court debt adjustments difficult. The more widely the debt is held, the more difficult a workout becomes. The drafters of Chapter 11 were well aware of this impediment, and they created the possibility of using Chapter 11 to implement a deal that the parties reached before a bankruptcy petition was filed. The new Code allowed for debtors to solicit consents to a plan of reorganization prior to a petition being filed.[19] The debtor would file the petition and the plan of reorganization at the same time, with the goal of having the proceeding wrapped up in a few months. This would be a "prepackaged" bankruptcy.

This device did not catch on quickly. From 1986 to 1990, there were a total of eight prepackaged bankruptcies. Their use, however, increased during the 1990s.[20] At the same time, creditors and debtors developed a modified version of a prepackaged bankruptcy. In a "pre-negotiated bankruptcy" the debtor and the

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[15] See Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U.L. Rev. 343, 358-67 (1997); Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 Ariz. L. Rev. 89 (1992); Lynn M. LoPucki, *The Debtor in Full Control – Systems Failure Under Chapter 11 of the Bankruptcy Code? (First Installment)*, 57 Am. Bankr. L.J. 99 (1983)

[16] See Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125 (1990).

[17] See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 Yale L.J. 1043 (1992); LoPucki & Whitford, *supra* note __

[18] See Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 Cornell L. Rev. 439, 448-49 (1992).

[19] See 11 U.S.C. 1125(g).

[20] See Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 Nw. L. Rev. 1357, 1388 (2000).

lead creditor group or groups would negotiate a debt restructuring, but not sign up sufficient creditors to guarantee success. The parties fully expected sufficient consent would be rounded up shortly after the petition was filed.

These prearranged bankruptcies use Chapter 11 to implement a deal that the parties strike before the bankruptcy case begins. They use the power to bind dissident creditors to combat the problem created by the Trust Indenture Act. Looking at the cases of large, publicly held companies that completed their Chapter 11 case in 2002, of cases were there was not a sale of company (more on that below), a majority implemented a deal that had been reached prior to bankruptcy. Specifically, this happened in 26 out of 41 cases.[21]

As dramatic as the increase in the number of prearranged deals was, even more dramatic was the rise in the use of Chapter 11 as a vehicle to sell the company. Indeed, what was once just an academic idea – the sale of a large company as part of the bankruptcy process[22] -- was becoming commonplace. Market sales were replacing traditional reorganizations. Indeed, over half of the cases that end in 2002 were sales. There were 93 cases of large, publicly held companies that exited Chapter 11 in that year. Fifty-two of these were sales of one sort or another. Some the sales occurred under Section 363 of the Code, while others were implemented though a plan of reorganization. Either way, companies were being acquired inside the Chapter 11 process. This was definitely not the negotiated solution contemplated by the drafters of Chapter 11. Combining the prearranged deals and the sales, well over 80% of the cases from 2002 could not be classified as traditional Chapter 11 cases.

The trend was unmistakable. Chapter 11 had, in the main, ceased to be the collective forum where parties negotiated a plan of reorganization. Rather, it had become a vehicle to implement a deal struck before the petition was filed or a venue to sell the company to the highest bidder. While there were a few cases that bore the hallmarks of a traditional Chapter 11, it was easy to conclude that "[t]he end of bankruptcy is indeed upon us."[23]

What accounted for this new regime? Control rights over the firm had become much more dynamic.[24] No longer where they vested firmly in the hands of management. The dynamics had shifted from one where the debtor was in

[21] See Baird & Rasmussen, *Twilight, supra* note --, at 679.
[22] See Douglas G. Baird, *The Uneasy Case for Corporate Reorganization,* 15 J. Legal Stud. 127 (1986).
[23] Baird & Rasmussen, *Twilight, supra* note --, at 699.
[24] See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance,* 154 U. Pa. L. Rev. 1209 (2006).

control of the bankruptcy process from beginning to end to one where the creditors dominated. No longer did the managers of the debtor have unfettered ability to run the business while in bankruptcy. Even before a bankruptcy petition was filed, control in many cases would shift from the debtor to the senior lender. The bankruptcy forum offered no relief. While some had talked about Chapter 11 providing a breathing space from a firm's creditors, now creditors were firmly in charge.

The shift in control was caused by a number of factors. Certainly changes in finance were a contributing factor. New types of investors began appearing on the scene.[25] These professional investors began to explore ways to profit from firms in financial distress. Starting in the 1990s, a market in the claims against the company developed.[26] This activity was fueled in part by the rise of hedge funds, especially those funds that specialized in dealing in distress debt. The effect of this change was that a single creditor or a group of creditors could get control of a class of claims. The rise of this market also had the effect of granting an exit option to those who did not want to maintain their relationship with the debtor. If a lender who was part of a syndicate became uncomfortable as the debtor's fortunes declined, it could sell its interest in the secondary market. Small creditors and those who did not want to participate in the resolution of financial distress could sell their claim to a willing investor, an investor well schooled in the dynamics of today's reorganizations.[27]

Another factor was recent amendments to Article 9 of the UCC. The 1998 amendments made it easier for lender (or more accurately a group of lenders[28]) to obtain a blanket security interest in all of the business's assets. Rather than disparate secured creditors each holding different collateral, new lending syndicates could lock up virtually all of the business's assets. In particular, it became easier to get a direct security interest in the debtor's cash. Through lending covenants, the senior lender could control the debtor's access to the cash in its accounts.

[25] Hedge funds that operate with an eye towards distress companies are only a part of the more general rise of hedge funds and their effects on corporations. See generally Institutional Investor Activism, William W. Bratton & Joseph A. McCahery, eds. (2015).
[26] See Miller & Waisman, *supra* note --, at 152-53.
[27] See Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy,* 119 Yale L.J. 648, 660-61 (2010).
[28] Most large loans are syndicated loans. See Steven C. Miller, A Syndicated Loan Primer 3 (2014).

The combination of these changes gave creditors and their lawyers room to innovate, both inside and outside of bankruptcy. [29] Capital structures become more attuned to the possibility of financial distress. The changes to Article 9 meant that the senior lending group could control the debtor's access to cash, thus allowing the lender to exert pressure on the company even before a bankruptcy proceeding is in the offing.[30] For example, rather than having to be beholden to current managers to steer the company, lenders could engineer the installation of a chief restructuring officer.[31] The CRO is not a typical part of the leadership team, owing fealty to the CEO. Rather, the CRO's allegiance is more with the senior lenders.

Bankruptcy offered no haven from the oversight of the senior lender. When the corporation filed for bankruptcy, it would often need cash to finance its operation, so-called "debtor-in-possession" financing.[32] The debtor could either reach an agreement with its existing lender to use cash collateral, or get a new loan, usually from the same group of lenders. Either way, these agreements came with strict terms. Covenants would require the debtor to hit certain targets. Failure to meet these targets could lead to putting the business on the auction block.

When the Bankruptcy Code first took effect, those who extend credit to the debtor were the ones who showed up in the bankruptcy proceeding. When a Chapter 11 was filed, the reorganization plan was negotiated among the debtor's senior bank, its trade creditors, its unpaid landlord; these were all players who often had a long-term relationship with the debtor. They had often extended credit in good times, and were now stuck with the bad. Few had made an investment in the debtor with the expectation that they were going to be faced with a Chapter 11 proceeding. After the changes in financing the debtor both outside and inside of bankruptcy, the debt was held, both before and during bankruptcy, by debt trading professionals. These are people who wanted a seat at the table and only came on the scene after the debtor had hit financial headwinds. They often pushed for a quick sale or a quick restructuring of the debtor's capital structure. The rise of hedge funds created pools of liquidity whereby there could be a cash sale for hundreds of millions of dollars.

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[29] As David Skeel has shown, the evolution of bankruptcy law in the United States has often been driven by bankruptcy lawyers. See David A. Skeel, Jr., Debt's Dominion: A History of Bankruptcy Law in America (2001).
[30] See Baird & Rasmussen, *Missing Lever*, *supra* note __ at 1223-36.
[31] See *id.*
[32] See 11 U.S.C. 364.

Whereas in the past bankruptcy was a procedure to be avoided if at all possible, it had become just another tool in the toolbox of sophisticated investors. Indeed, there arose a group of investors known as the "loan to own" crowd. Such investors would either make a new loan to a distressed debtor, taking a first position in all of its assets, or buy into the existing debt. Regardless of the method, the goal was to have a claim against the debtor that both gave the lender control over the debtor and, if the debtor stumbled, allowed the lender to takeover the debtor as part of the Chapter 11 case.[33]

This shift to creditor control was not a boon to managers. One would expect managerial turnover to increase during this period. Senior creditors could engineer the ouster of the current leader, and there is no reason to suggest that they would be overly sympathetic to managers in which they had lost faith. While there does not seem to be a comprehensive study on this matter, the evidence does at least suggest that managers were facing worse in the era of creditor control. For example, in looking at cases where a bankruptcy petition was filed in 2001, Ayotte and Morrison found that CEOs were replaced 70% of the time before the petition was filed.[34] This compared to a replacement rate of roughly 55% prior to the era of creditor control.[35] While these two studies differ somewhat in their methodologies, it is safe to say that by the year 2000, bankruptcy was not a sanctuary for underperforming CEOs.

Nor was the shift to creditor control beneficial to shareholders, at least in terms of what they could expect to receive at the end of the Chapter 11 proceeding. In the cases that concluded in 2002, there was little distribution to equity holders. Ayotte and Morrison found the same pattern, as did Adler, et al. To the extent that deviations from the absolute priority were commonplace in the 1980s, this practice had ended with the rise of creditor control in the 2000s.

II. *The End of Bankruptcy* Today

Bankruptcy case filings fluctuate depending on broad economic conditions. The last two decades have seen dramatic swings in the economy, and, not surprisingly, dramatic shifts in the number of Chapter 11 filed. While there has been variation in the number of Chapter 11 cases, the dominance of sales and prearranged deals has remained constant. From to 2001 to 2007, there was a

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[33] See David A. Skeel, Jr., *Creditor's Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Penn. L. Rev. 917 (2003).
[34] See Ayotte & Morrison, *supra* note --, at 522.
[35] See Stuart C. Gilson, *Management Turnover and Financial Distress,* 25 J. Fin. Econ. 241 (1989).

dramatic decline in the number of large Chapter 11 cases. In 2001, 263 public companies filed for bankruptcy, and by 2006 this number dropped to 78. Looking only at the large, public companies, there were 97 cases filed in 2001 and only 13 in 2007. [36] Bankruptcy practice during this period continued largely the same as it had been in the immediate past, with creditors in control and a dominance of sales and prearranged deals. Then financial Armageddon hit. Beginning in 2008, there was a financial upheaval unlike anything that we have witnessed before. The Great Recession shook the country's financial architecture to the core. Unprecedented government action was necessary to save the banking system. Assets plunged in value. Iconic companies such as General Motors and Chrysler encountered financial distress, and had that distress resolved in unprecedented fashion.

We are now on the backside of the Great Recession. A quick snapshot of recent cases shows that today's outcomes are not much different from what they were prior to 2008. It is still the case that traditional Chapter 11 cases are few and far between. One way to see this is to look at the cases that emerged from Chapter 11 in 2014 and compare the pattern that exists today with the one that obtained before the financial crisis.[37] In 2002, there were 93 cases of large, publicly held companies that completed their bankruptcy proceedings. Of these, 78 were either sales or pre-arranged deals. Of the remaining 15, at most four had going-concern value that could be saved through a traditional Chapter 11. Other studies found a similar pattern. Ayotte and Morrison examined a sample of 153 large privately and publicly held firms that filed for bankruptcy in 2001. They found that two-thirds of these firms were either sold or liquidated.[38]Another nine percent of these cases were prenegotiated deals.[39]

The same general pattern still holds. In 2014, 21 cases that began with the filing by of a Chapter 11 petition by a large, publicly held company were completed.[40] Sixteen (76%) of these were either going concern sales or pre-

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[36] There was a similar decline in all Chapter 11 cases as well. In 2001, there were 11, 424 Chapter 11 cases nationwide; in 2007, the number was 6,352. The 2015 Bankruptcy Yearbook & Almanac 2015, 3. In 1991, there had been 23,989 such cases. *Id.*

[37] In terms of the total number of Chapter 11 cases filed, the number for 2014 was a tad higher than it had been in 2007, with 7,234 Chapter 11 cases filed in 2014. *Id.*

[38] Kenneth M. Ayotte & Edward M. Morrison, *Creditor Control and Conflict in Chapter 11,* 1 J. Legal Anal. 511, 520 (2009)

[39] *Id.* at 520 & n.12.

[40] These cases come from Lynn LoPucki's database. One thing that has not changed is the usefulness of this project. It remains the leading source of information on large firm bankruptcies.

arranged deals.[41] Just as was the case a decade ago, the lion's share of the cases of large public companies that enter Chapter 11 are either sold or implement a deal that the creditors had reached prior to filing. Indeed, it is now widely accepted that sales are a common occurrence in Chapter 11.[42]

Even when we look at the five cases from 2014 that were neither a sale nor prearranged deal, we do not see traditional reorganizations across the board. Of the five cases that were not sales or pre-arranged deals, three had no going concern value. Two (ATP Oil and Gas and China Natural Gas) ended up being converted to Chapter 7 for liquidation, and a third (Team Financial) – a bank holding company with no assets – was dismissed.

Of the remaining two cases, one (MModal) was a restructuring of a leveraged buyout. The company had been taken private in August of 2012. It soon became apparent that it could not service its debt. Negotiations began well before the bankruptcy petition was filed, and though there is no indication that an agreement was in hand at the time of filing, though it seems to be the case that the parties were close to a deal at the time of filing. The plan was confirmed four months after the company entered Chapter 11.

The last case (Overseas Shipholding Group) comes closest to a traditional Chapter 11 case. The debtor was the world's largest owner of oil tankers. It had an existing credit facility that it had entered into in 2006 that was due to be refinanced in the near future. Before it could do so, however, the debtor disclosed that, due to tax issues that had arisen, investors could not rely on the company's financial statements for the past three years. This announcement, and a subsequent downgrade by the rating agencies, had the effect of closing the capital markets to the company, and it could not replace its expiring credit facility. It filed for bankruptcy to prevent creditors from seizing collateral – the company's ships – should it default on its obligations. The company had sufficient cash flow from its operations to fund the bankruptcy case itself. The case lasted a bit more than a year and a half. The debtor rejected over 25 contracts that had become burdensome, and relocated its company headquarters. All the creditors were either paid in full or had their claims unimpaired.

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[41] These cases are Capital Bankcorp, Coldwater Creek, First Mariner Bancorp, Furniture Brands International, Global Aviation Holdings, Lifecore Holdings, Mercantile Bancorp, Tweeter Home Entertainment Group, Edison Mission Energy, Fiber Tower Corporation, GMX Resources, Momentum Performance Materials, USEC, Dolan Company, Eagle Bulk Shipping, and Genco Shipping and Trading Limited.

[42] See, e.g., Daniel S. Zazove, *Confidentiality Issues Arising Under Section 363 of the Bankruptcy Code,* Business Law Today 1, 1 (August 2015) ("the majority of recently filed Chapter 11 cases have resulted in going-concern sales").

While the outcomes of the cases today remain roughly the same as they were a decade and a half ago, there have been some developments worth noting. As sales have continued to be a regular occurrence in Chapter 11, more and more attention has been given to how they are handled by the bankruptcy court. Currently, the Bankruptcy Code does not provide any guidance as to how a sale should be run. There is a legitimate concern with the process. Sales can be conducted well or conducted poorly. Moreover, a sale carries the potential for abuse, as a party in control could orchestrate a quick sale at a reduced price, especially where it is part of the successful bidding group. What we have seen, however, is the development of standard protocols.[43] Along these same lines, the American Bankruptcy Institute Chapter 11 Reform Commission recommended that auction procedures be placed in the Code. For example, the Commission proposes that to ensure a robust auction, such a proceeding not take place within the first 60 days of the proceeding, unless there is a clear and convincing showing that delay will result in a significant decrease in the value of the debtor's assets.[44]

While bankruptcy activity today, at least in terms of sales and prearranged deals, is roughly similar to what it was fifteen years earlier, the pattern was notably different during the Great Recession.[45] It is instructive to look at the pattern of cases that were handled during the Recession, as this provides some purchase on the factors that drive the bankruptcy practice in the modern era.

Sales and prearranged deals still took place during this period, but with a noticeable shift from sales to prearranged deals. The years 2007 and 2008, immediately prior to the Recession, still saw the dominance of sales. In 2007, 9 out of 13 cases of large, publicly held corporations that were filed that year were either sales or prearranged deals, with sales outnumbering deals five to four. In 2008, 22 out of 35 cases filed were one of these two types, with 16 sales and six prearranged deals. 2009 saw a noticeable shift in the relative mix of sales and prearranged deals. That year was by far the peak year for Chapter 11 filings during the Recession, with 84 cases being filed. While sales and prearranged deals still constituted a large majority of these cases, the relative proportion of each changed radically. Of these 84 cases, there were only 19 sales, but there

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[43] See, e.g., *In re* Adoption of Amended Guidelines for the Conduct of Asset Sales, General Order Amending M-331, M-383 (Bankr. S.D.N.Y. Nov. 18, 2009).
[44] See Commission to Study the Reform of Chapter 11, American Bankruptcy Institute 83-87 (2014).
[45] One change is that there was a rise in the Chapter 7 filing of bank holding companies, with four in 2008, seven in 2009, and eight in 2010.

were 31 prearranged deals. This trend of the dominance of prearranged deals continued for the next two years. In 2010, there were 28 cases filed, with six sales and 13 prearranged deals. Finally, in 2011, of 21 cases filed that year, three were sales and nine were prearranged deals. Once the pressures of the Great Recession receded, the pattern the existed prior to 2008 returned, with sales again taking the lead, and sales and prearranged deals accounting for the bulk of Chapter 11 cases, at least those involving large, publicly held companies.

The shift away from sales towards deals during the Great Recession should not be a surprise. As Shleifer and Vishny pointed out, at times the market may be illiquid. It could be that there is a general liquidity shortage, or that the most valuable buyer is another company in the industry and the entire industry is experiencing financial pressure.[46] Certainly the Recession reduced the overall amount of liquidity in the economy and put tremendous pressure on a number of sectors. Faced with this state of affairs, one should expect a decrease in the number of sales, at least until more benign conditions return.

Consider in this vein American Airlines. American Airlines was the last of the legacy carriers that was still in existence (Pan Am, TWA and Eastern had all ceased flying by 2001) and had not filed for Chapter 11 (U.S. Airways and United filed in 2002, and Delta and Northwest filed in 2005). American finally joined its brethren and filed in November of 2011. At the time, American had the highest operating costs in the industry, and it filed for bankruptcy so that it could use the provisions of Chapter 11, especially Section 1113, to lower these costs. The airline industry, which had been hard hit by the Recession, was in a wave of consolidation. The best partner for American was likely another airline. During the Recession, however, it is unclear whether any of its competitors had the financial resources to buy American at auction. The CEO of US Airways approached the CEO of American, expressing interest in a merger. American's CEOI rebuffed these efforts. The leader of US Airways then approached American's unions (70% of American's workforce was unionized). He was able to reach a deal for new contracts with the unions, contingent on American merging with US Airways. This tactic forced American's hand, and US Airways essentially took over American, including its name.

This takeover of American by US Airways cannot be confused with a traditional reorganization. This is was a competitor using Chapter 11 to engineer a hostile takeover of a rival. While there may not have been sufficient liquidity for US Airways to buy American for cash at an auction, another mechanism was found to have American taken over by its rival. While the Great Recession may

[46] See Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. Fin. 1343 (1992).

have constrained the ability to sell companies as part of a Chapter 11 reorganization throughout the period, lawyers were still able to adapt its procedures to facilitate moving assets from the debtor to other entities.

Of course, it would be hard to look back over the past decade and a half and not have at least a brief mention of the automotive bankruptcies.[47] In 2009, we saw two of the largest Chapter 11 cases ever, General Motors and Chrysler. Both were structured as sales, and to this extent they both illustrate the current use of sales as a routine part of Chapter 11 and raise the issue of how should sales be structured. Of course, they were more than this. What we saw here was the unprecedented involvement of the government in the insolvency process. GM and Chrysler were on shaky financial ground prior to the Recession. With the Recession, which led to a dramatic slow down in car buying, they were hopelessly insolvent. Prior attempts to stabilize the industry had left the government as a major creditor of both companies. In GM, the government had the senior position, whereas in Chrysler the government's loan was behind that of a syndicate of secured lenders. In February 2009, President Obama established a Presidential Task Force to examine these to companies. The government decided to rescue them, using funds from the Troubled Asset Relief Program (TARP). The government used the mechanism of a 363 sale as a way to accomplish the goal. In essence, GM was recapitalized and Chrysler was sold to Fiat. The goal may have been enlightened or misguided, but it certainly was not your father's Chapter 11.

Interestingly enough, in recent years cases that bear some of the hallmarks of traditional bankruptcies have reappeared, though in a very different context. They can be found in Chapter 9 rather than Chapter 11. The recent spate of municipal bankruptcies resembles the traditional free-fall bankruptcy much more than does today's modern corporate reorganization. There is no question that a city has a going-concern value. A city is a place where people live, and one does not redeploy a city's assets in the market through a liquidation. Similarly, it makes little sense to talk of a going concern sale when it comes to a city. The city is a dedicated jurisdiction that is going to remain in existence going forward. What is needed is a new capital structure, one that will allow the city to provide basic services to its residents. Here is a situation well suited to bankruptcy's vision of a negotiated reorganization among relevant stakeholders.

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[47] Insightful work on these cases includes Barry E. Adler, *Reassessment of Bankruptcy Reorganization after Chrysler and General Motors*, 18 Am. Bankr. Inst. L. Rev. 305 (2010); Douglas G. Baird, *Lessons from the Automotive Reorganizations*, 4 J. Legal Anal. 271 (2012); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 Mich. L. Rev. 727 (2010).

Consider Detroit. It had years of mismanagement as well as a shrinking manufacturing base due to the decline of the auto industry. These factors resulted in a declining population and deteriorating services. Indeed, from the high point in the 1950s to its bankruptcy filing, Detroit had lost over half of its population. Various obligations meant that it was hopelessly insolvent. The city owed $18 billion in total, more than it could ever pay back. Over half of this amount was owed to retirees through unfunded health and pension liabilities.[48] The relationships among the creditors were fraught. The financial creditors were adamant that whatever adjustments were needed had to respect the priority structure of the debt. Moreover, within any priority level, they insisted that it needed to be share and share alike. Union leaders were equally adamant that their retirees, who depended extensively on their modest pension, be shielded from as much pain as possible. Here, the only feasible option is a negotiated settlement among the parties. [49]

In the end, Detroit was able to use the Chapter 9 process to lop off about $7 billion in debt. It was also able to procure $1.7 billion to invest over the next 10 years in rebuilding the city. Detroit is a case where the bankruptcy forum was used to give the city a breathing spell where the various parties in interest could sketch out a course for the future.[50]

Still, the fact the one has to look to the municipal setting to find traditional bankruptcies underscores how much bankruptcy practice has changed in the last twenty years. Few question that we now live in a world of creditor control (even when they fight amongst themselves) where sales and prearranged deals are the norm. It remains uncertain, however, as to whether these changes have improved the operation of Chapter 11. Indeed, the biggest challenge in corporate bankruptcy law may be in trying to answer this question.

It is one thing to describe this system, a system that takes place far away from the pages of appellate reporters. Equally pressing is the evaluative question – did the changes improve the efficacy of the system? This is a pressing question, but it is difficult to address satisfactorily in an empirical analysis for a number of

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[48] The challenge of dealing with legacy pension obligations is straining the finances of many cities. Whether these pensions can or should be adjusted in a Chapter 9 proceeding is perhaps the most contentious issue surrounding municipal bankruptcy today.

[49] To be sure, the city did have some assets that could in theory be sold, most notably its art museum. The city was able to keep the museum, as outside groups donated funds equal to the value of the museum.

[50] For a description of the complex negotiation and maneuvering that took place in Detroit's bankruptcy proceeding, see David A. Skeel, Jr., *From Chrysler to General Motors to Detroit*, 24 Widner L.J. 121, 136-46 (2015).

reasons. The ideal Chapter 11 would, as a matter of first order, deploy the debtor's assets to their highest valued use. It may be that the debtor should be shut down because it lacks any going concern value. Alternatively, it may be that selling the debtor to the highest bidder would bring the best returns. Finally, there may be situations where a negotiated solution is the right course. While we can observe what happens in any given case, we cannot observe the counter-factual – what would have happened had to any given firm another path been followed.

To be sure, one can run comparisons across companies, but here there are challenges. In any given year, there may not be that many cases. Also, what happens to a debtor is not a random event. It is not as if businesses are randomly chosen to be sold while others are selected for a more traditional reorganization. Those in charge (usually the creditors) select what option they view as best for them. They could, of course, be wrong in their judgment. Moreover, they could have interests that run counter to the group as a whole. On the other hand, there are cases were maximizing the value of the business maximizes their return. It is difficult to resolve this question based on either theory or empirical analysis.

Even if one could assess whether Chapter 11 is disposing of assets in the best manner possible, one would still have assess how Chapter 11 affects behavior in advance of bankruptcy. As Adler, et al. have pointed out, a regime that terminates managers quickly and eliminates equity's interest in full may induce some managers to try to take exorbitant risks to avoid bankruptcy at all costs. If so, one would have to balance this potential value destruction against the better deployment of the assets. Of course, even that would not complete the analysis. It may be that a regime that quickly terminates managers, while inducing them to take reckless gambles once they are in financial distress, may also make them so wary of the consequences of financial distress that they lean towards efficient investments so as to avoid financial distress in the first instance.[51]

Finally, there is the cost of the system itself. Commentators have questioned the cost of Chapter 11 for years.[52] Whether the evolution of Chapter

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[51] See Adler, *supra* note __; Lucian A. Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. Fin. 445 (2002).
[52] See, e.g., Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. Fin. 1067 (1984); Bris, et al., *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 66 J. Fin. 1253 (2006); Lynn M. LoPucki & Joseph W. Doherty, *Professional Overcharing in Large Bankruptcy Reorganization Cases*, 5 J. Empirical Legal Stud. 983 (2008).

11 has lead to a reduction of the actual cost of the proceeding is part, admittedly small, of assessing the overall impact of this change.

There have been attempts to address some of these issues. LoPucki, in looking at cases from 2000 to 2004, found that sales brought lower prices than reorganizations.[53] He had no way of concluding that this was a treatment effect – quick sales fetch less than market value, or a selection effect, those in control sell the poorer performing companies but reorganize the more valuable ones. Ayotte and Morrison found that when senior lenders were in control, they were more likely to sell than to reorganize the business, a finding that is consistent with senior lenders selling only to get what they are owed rather than maximizing the overall price.[54] Adler, et al., found that debtors in the new era come into bankruptcy more heavily indebted.[55] They conjecture that the managers knowing that they are not going to fare well in today's Chapter 11, borrow as much as they to try to turn things around outside of bankruptcy. They acknowledge that this finding is ambiguous as to whether this implies that Chapter 11 has become or less efficient in the new era.

Conclusion

Chapter 11 marches on. The number of cases filed in any given year ebbs and flows with the economy, though the long-term trend remains downward. Creditors continue to use it as they see fit. Whatever Chapter 11 once was, it is now something else. It has become another venue where those with the financial wherewithal scour the landscape looking for ways to increase their returns. Bankruptcy has come and gone.

[53] Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales,* 106 Mich. L. Rev. 1 (2008).
[54] Ayotte & Morrison, *supra* note --, at 539.
[55] Adler, Capkun & Weiss, *supra* note --, at 465-78.