Goodbye to Chapter 11: The End of Business Bankruptcy As We Know It

by John D Ayer

This paper is about business reorganisation under Chapter 11 of the United States Bankruptcy Code. In brief, I assert that Chapter 11 once was used to preserve the interests of equity owners, while now it is used to preserve the value of assets. The change is all the more interesting for the way it came about. It is not the result of any specific decision, or even any conscious shift of attitude. It is much more the result of a more or less subconscious sea change in our perception of the problem.

The point requires some explanation, and not only because I write for a non-US audience. The core problem is to define what we intended to be the purpose of Chapter 11 in the first place. And the remarkable fact is that we have no idea.

First, background. The Constitution provides that Congress shall have the power to pass bankruptcy laws. Congress enacted the current Bankruptcy Code in 1978, although a predecessor extends back to 1898. The Code is organised into Chapters. For example, Chapter 7 provides for simple liquidation – the case where the residuary owners throw the keys on the table and the trustee undertakes to liquidate the assets and distribute the proceeds among creditors as their interests may appear.

Chapter 11 provides for 'reorganisation'. But the Code nowhere defines 'reorganisation'. This is noteworthy in itself, given the fact that the Code includes a general catalogue of 50-odd definitions, as well as another 20 or 30 specific definitions scattered through the Code at large. But the absence is probably not accidental: the likelihood is that the drafters knew they were leaving a critical term undefined, and that they intended to leave the definition to the genius of the common law.

When lawyers undertake to explain Chapter 11, they typically say something about how a purpose of Chapter 11 is to 'save the business'. But there is an ambiguity here. When we say 'save the business', we could mean either of two things. We could mean, on the one hand, to preserve a (higher) 'going concern value' as distinct from realising the (lower) 'liquidation value' that creditors might accrue if the assets are dissipated piecemeal. Or we could mean, on the other hand, to preserve the residual stake of the equity owners.

These purposes may go together, but they need not, as we can see from a couple of examples. Consider, first, this balance sheet:

Assets		Liabilities & NW	
	$80	L	$100
		NW	($20)
Total	$80	$80	

This is the simple case where the residuary owners – the equity — might as well throw the keys on the table. There isn't enough to go around and there will be nothing left for them. Contrast this case:

Assets		Liabilities & NW	
	$80 (Liq)	L	$100
	$120 (GC)	(?)	
Total	(?)	(?)	

This is the much different case in which the assets are worth only $80 in liquidation, but will be worth $120 in a going concern. The residual owners have every incentive to go to the creditors and say: both ends of the boat are sinking. Let's work together and preserve the higher going concern value. The incentive for you is that you get paid. The incentive for us is that we get to keep our residuary stake.

These first two examples are almost non-problematic. But now, take a more contentious case. The balance sheet looks like this:

Assets		Liabilities & NW	
	$80 (Liq)	L	$100
	$90 (GC)	NW	(?)
Total	(?)	(?)	

Again, going concern value exceeds liquidation value. But this time, it falls short of the sum necessary to satisfy claims of creditors. The residual owners propose to 'reorganise' with a new balance sheet that looks like this:

Assets		Liabilities & NW	
	$90	L	$85
		NW	$5
Total	$90		$90

The residuary owners are saying to the creditors: if we preserve the going concern value, the assets are worth $90, but you will never see any more than that. We propose that you accept reorganisation based on a value of $90, but that you leave $5 on the table for us.

One's first thought may be: why would creditors ever enter into a deal like this? But in fact, the deal is more plausible than may at first appear. Here is a typical case: the residual owner is also the manager of the debtor. His pitch is: you can't preserve the going concern value without me. This is a limited liability entity, so I can walk away. But I won't walk away if you accept a reduction in your claim and leave me with my equity stake.

So, on closer scrutiny, once again there may be a possibility for a deal that benefits everyone. But this fact suggests a provocative question. That is: if both debtors and creditors have incentives to make a deal, then why do you need Chapter 11? There are two answers to this question. The first is – maybe you don't need Chapter 11. Indeed, creditors and debtors do deals like this every day without any court intervention at all. But the second answer is – absent Chapter 11; there may be practical obstacles that prevent deals of this sort even where most of the creditors (and equity owners) agree.

For example, consider this balance sheet:

Assets		Liabilities & NW	
	$25 (Liq)	A	$25
	$40 (GC)	B	$25
		C	$25
		NW	(?)
Total	(?)		(?)

In words: the debtor owes $25 to each of three creditors. The assets may be worth $25 in liquidation, or $40 as a going concern. If creditors are to divide assets pro rata, then they have an incentive to protect the value of the going concern. But no single creditor has the same incentive: the single creditor has the incentive to get his $25, even if it means destroying the going concern and leaving others empty-handed.

A similar problem arises when it comes time to make a deal. Suppose that (for whatever reason) you can't preserve the going-concern value unless all creditors are on board. Then any individual creditor has an incentive to hold out, and to induce other creditors to buy his participation by giving him a relatively larger share of the reorganised debtor.

Another way to make this point is to approach it as an aspect of the bankruptcy 'discharge'. The very notion of a 'discharge' in a corporate bankruptcy is an oddity. After all, independent of bankruptcy, the corporation has its discharge built-in. The essence of the corporation is the idea of limited liability: the equity owners risk only the capital they invest in the firm. If there won't be enough left to reach them, then they effect a discharge simply by walking away. This isn't just an incident of the corporate form – rather, it is the operational definition.

But if the business will continue as a going concern, then the problem is more complicated. Of course any individual creditor can agree to reduce or surrender a claim. But to make a deal work, you may need to get them all to reduce together. And any event, the parties will want to know just which claims are being reduced, and by how much.

Problems like this may be solvable when the numbers are small. But the more creditors, the harder it will be to make it happen. Indeed, just getting everybody organised, and gathering the necessary information about claims and assets, may be enough to stop any deal at the threshold. You find yourself aching for a mechanism that will facilitate deals that make sense.

Which is, of course, precisely what Chapter 11 purports to do. It puts structure on the case by providing for the scheduling of assets and claims. It imposes an automatic stay against unilateral creditor action. Perhaps most dramatic, it imposes the deal on dissenters. And it provides for a 'clean' discharge, that tells the world just which claims go away.

So to recap: on this reading, Chapter 11 functions to implement deals that creditors (and owners) would make if they could on their own. Going concern values are maximised. Equity owners get to retain their stakes. No one is hurt except the odd 'holdout', and everyone goes to the seashore. But this view is too benign for belief. Surely there must be more to it than we have seen here?

There is more. In fact, there is quite a bit about Chapter 11 to suggest that it might function to protect equity owners as distinct from going concern values – or, perhaps more precisely, equity owners at the expense of creditors.

The point of departure for this view is a fact of life for insolvent debtors. The fact is: the residual equity owners always gain from more time. To see that this is so, reconsider our first balance sheet:

Assets		Liabilities & NW	
	$80	L	$100
		NW	($20)
Total	$80		$80

But now, consider some facts that the numbers don't tell you. Specifically: the assets would yield $80 if liquidated today. If you wait for a year, they might be worth nothing – or they might be worth $160, with a 50 percent chance of each outcome. In terms of simple probabilities, this pencils out to a value of $80:

0.5 ($ 0) + 0.5 ($160) = $80

... So everything seems to check. But from the standpoint of the creditors, it does not check. On these numbers, if we wait a year, then the creditors have only a 50 percent chance of getting paid. This means that the 'weighted' value of their claim is not $100, but just $50:

0.5 ($ 0) + 0.5 ($100) = $50

Meanwhile, equity has a 50 percent chance of getting $160 (less the amount necessary to pay off debt):

0.5 ($ 0) + 0.5 ($160 - $100) = $30

So a 'revised' or 'probability-weighted' balance sheet looks like this:

Assets		Liabilities & NW	
	$80	L	$50
		NW	$30
Total	$80		$80

The face value of the debt remains $100, of course, but these probability-weighted values are the ones that traders will use in buying and selling the distressed debt on the secondary market. Of course, on these numbers, no individual claim will ever pay off at exactly $50. But think of it like insurance: the insurer takes $100 from each of 1,000 people to insure against the one-in-a-thousand risk of losing a $100,000 car. The insurer will pay either (a) nothing or (b) $100,000 – never $100, even though that is the 'value' of the claim.

So equity has every incentive to wait. Remarkably, Chapter 11 not only permits equity to wait. It actually mandates waiting, in that it provides for a so-called 'exclusivity period' (typically 120 days) during which only the debtor (read: the equity owners of the debtor) may propose a plan.

To see why this is important, consider a 'plan' to dispose of the assets by sale distributing the assets among creditors as their interests may appear. Such a plan is clearly permissible under Chapter 11. But no equity owner will ever propose such a plan as long as he has hope for the future.

The reader may object that the managers of the assets still have the obligation to maximise asset value – and that is true. The trouble is, maximising asset value may itself prove harmful to the creditors. To see that this is so, reconsider our previous example, where the liabilities were $100 and the quick-sale liquidation value was $80. We saw that the equity owners might gain (at the expense of the creditors) by waiting and taking a risk. Consider this strategy again, but this time assume that 'wait and risk' will yield a 50 percent chance of $220 (rather than $160) and (as before) a 50 percent chance of zero. Now, the weighted value of the assets is:

0.5 ($ 0) + 0.5 ($220) = $110.

But the weighted value of the debt remains:

0.5 ($ 0) + 0.5 ($100) = $50

Meanwhile, the weighted value of the equity becomes:

0.5 ($ 0) + 0.5 ($220 - $100) = $60

And the 'probability-weighted balance sheet' becomes:

Assets		Liabilities & NW	
	$110	L	$50
		NW	$60
Total	$110		$110

The point is that in this case, the 'asset' view and the 'equity' view of Chapter 11 are at war with one another. Equity's risk-taking damages creditors even as it maximises asset values.

So the Code seems virtually to mandate a kind of risk-taking that may help to preserve the old equity stake, even as it damages creditors

A second rule provides even more help to old equity owners, even though its policy grounding is less clear. Recall that in an ordinary bankruptcy case, a trustee is appointed who takes charge of the assets and distributes the proceeds to creditors as their interests may appear. But not so in Chapter 11. In Chapter 11, the 'debtor' (read: the old equity owners) remains in possession unless the court chooses to oust them.

This is surely one of the most important features of Chapter 11, and perhaps one of the most misunderstood. The rule surely appears to favour the old equity owners, and in many cases it surely does so (of which more in a moment). But it has a dual purpose. Indeed, in many cases, the rule serves the interests of creditors at least as much as those of equity.

To see why this is so, recall that if you appoint a trustee, you have a new round of cost, and inefficiency as the trustee masters is brief. If the old equity owners are honest and competent (but merely unlucky), then creditors may well profit from leaving them in control and saving the costs.

So the Code leaves the debtor in possession —the Code title is 'debtor in possession', usually short-handed as 'DIP'. This DIP has the responsibilities, as well as the powers, of a trustee. But no one expects the debtor in possession to act as adversely towards 'himself' as would a fully independent trustee – and at any rate, he does not. The statute also specifies that the court can oust the debtor in possession at any time 'for cause'. In fact, courts rarely do oust the debtor in possession. It would be fascinating to know whether the drafters intended the courts to give such leeway to the old owners, but in any event, they do.

Or perhaps it is better to say, 'they did'. There is abundant evidence to confirm that equity owners used Chapter 11 in the 1980s, even at the creditors' expense. But lately, the tide seems to be turning. More precisely, debtors and creditors continue to use Chapter 11. But they use it now in a different way. As I suggested above, they use it to protect asset values, independent of (or perhaps even at the expense of) equity owners.

I offer this as an assertion, not a demonstration. But if I am right, it amounts to a radical shift in perspective on the rule of Chapter 11. And it has occurred, as I say, without any conscious or formal decision. So the question arises – if all this is so, what could make it so? What sorts of changes could have led to such a shift in perspective, all without anyone noticing?

There are several possibilities. One is the unexampled strength of the economy. Debtors still get in trouble, of course – even in good times – but the consequences are not so dreadful. The unluckiest owner is likely to be able to find an exit strategy – a new business, or at least a new job, that will take the edge off his misfortune.

Closely related is a subtle but important shift in our conception of the rules of debt and equity. An older view draws a metaphysical distinction between creditors and holders of equity stakes. Equity stakeholders are 'the owners'. Creditors are 'others', whose rights have to be respected, but who remain outsiders. You can see this view in the Code itself, which frequently refers to 'the debtor' when it seems to mean 'the majority in amount of the equity claims'.

A newer view eradicates this discontinuity. It treats debt and equity as two different kinds of contract claim. On this view, the asset doesn't know who owns it, and you can't expect to change asset values by changes on the credit side of the balance sheet. Equity still has a place at the table on this view, but it is no longer special.

A third reason why things seem to have changed is that creditors are wilier than they used to be. The structure of Chapter 11 is that it puts the aces in the equity owners' sleeve. But creditors, after a few years of stunned confusion, appear to have learned how to trump the aces with counter-strategies of their own.

There is a fourth possibility, perhaps accidental, but no less important. It happens that there was a great personnel turnover among bankruptcy judges about 1984. Many of the judges went on the bench as fresh faces back then. Many of them are still there, some 17 years wiser than when they began. Is it possible that judges are more sceptical now, less tolerant of ingenious excuses, than they might have been a decade ago?

If it is true that Chapter 11 has lost its role as a device for the protection of equity, then what is its role today? The answer is that it offers all the advantages that we saw in our preliminary sketch at the beginning of this essay. Go back to our earlier example that looked like this:

Assets		Liabilities & NW	
	$80 (Liq)	L	$100
	$90(GC)	NW	(?)
Total	(?)		(?)

Earlier we saw how equity owners might try to use bargaining skill plus an appeal to self-interest in trying to retain a slice of a going concern for themselves. But it doesn't have to work that way. Here, creditors have an interest in preserving the going-concern value even if the equity is wiped out. The simplest way is simply to cancel all the old interests and create a new balance sheet:

Assets		Liabilities & NW	
	$90 (GC)	L	$0
	$90(GC)	NW	$90
Total	$90	$90	

The 'old' claims are gone (along with the old equity), and the 'new' equity belongs to the 'old' creditors. Think of it as a sale of the business to the creditors. A close variant is simply to sell the assets as a going concern to a stranger, and then distribute the proceeds among creditors (sic – not equity) as their interests may appear.

Can Chapter 11 help in this situation? It can prevent piecemeal foreclosure. It can stifle (or at least tame) potential holdouts. It can give a kind of closure to a proposal for a global settlement of debts. In short, it can do just about everything it may have been designed to do in the first place – unless, of course, it was designed to serve the interests of the old equity owners.

John D Ayer

Professor of Law, University of California at Davis; Fellow, American College of Bankruptcy