Shaping bankruptcy. What form should it take?

Jochem M. Hummelen

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Introduction

The structure of bankruptcy law regarding reorganizations in the United States and the Netherlands has been roughly the same over the past decades. In both countries a bankruptcy is governed by the rules laid down in a specific bankruptcy statute and a judge is involved in overseeing the procedure.[2] Especially in the Netherlands there has been relatively little discussion about this structure. The structure of bankruptcy law, however, should not be taken as a given. This Article calls the current structure of bankruptcy law into question and aims to provide an answer to the question what form bankruptcy law, in particular the law with regard to reorganizations, has to take in order for it to be efficient.[3]

This Article takes Chapter 11 of the U.S. Bankruptcy Code and the Dutch Bankruptcy Code (*Faillissementswet*) as a starting point. With this frame of reference three different kinds of alternatives for the administrative reorganization procedure that have been advanced in the past are discussed and assessed on their merits. These kind of alternatives are: i) ex ante capital structures, ii) mandatory auctions and iii) options-theory.[4] By comparing the different alternatives for a reorganization, benefits and costs can be weighed. In the end some observations will be made with regard to existing bankruptcy law.

The outline of this Article is as follows. Part A provides for a sketch of current American and Dutch bankruptcy law. In Part B the administrative reorganization procedure in general and alternatives for this procedure are discussed. Special attention will be given to the question whether the different alternatives solve contended problems of the administrative reorganization procedure and whether the proposals do not introduce other inefficiencies. In Part C the contended inefficiencies of critics are weighed and observations are made. Part D contains a general conclusion.

Part A

1. Bankruptcy procedure in the U.S.

The current U.S. Bankruptcy Code entered into force in 1978.[5] It is laid down in Title 11 of the U.S. Code.[6] For corporate debtors the most important parts of the Bankruptcy Code are Chapter 7 and Chapter 11.

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[2] This kind of structure will be referred to as an administrative reorganization procedure.
[3] This Article is limited to efficiency of bankruptcy law with regard to corporate debtors. In this respect efficiency is defined as economic value maximization. In this Article no attention will be given to the question whether economic value maximization should be the only goal of bankruptcy law. See for an overview of this discussion: Douglas G. Baird, *Bankruptcy's uncontested axioms,* 108 Yale L.J., 573 (1998). All the proposals that are discussed in this Article and which aim to provide a more efficient alternative for bankruptcy law use this same measuring stick.
[4] The reason that specifically these alternatives are being discussed, is that they are the most complete alternatives for the administrative reorganization procedure and have figured prominently in the scholarly debate over the last two decades.
[5] Its last major modification took place in 2005 with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (BACPCA).
[6] The current Bankruptcy Code was preceded by the Bankruptcy Act of 1898. This Act was also called the 'Nelson Act' and was the first modern federal bankruptcy law of the United States. It was significantly amended in 1938 by the Chandler Act.

Chapter 7 provides for a court supervised liquidation of a debtor. A Chapter 7 case begins with the filing of a petition with the bankruptcy court.[7] This filing triggers an 'automatic stay', which means that collection efforts against a debtor are stayed.[8] Furthermore, after filing a petition the U.S. Trustee appoints a trustee to administer the case and liquidate the assets of a debtor.[9] These assets can be sold either piecemeal or jointly. In case of a corporate debtor the last kind of sale is called a 'going-concern sale'. After the sale of the assets of a debtor the proceeds are distributed among the creditors and the bankruptcy ends.[10]

A debtor can also file for a Chapter 11 bankruptcy.[11] Chapter 11 of the Bankruptcy Code provides for the reorganization of a debtor.[12] Filing of a Chapter 11 petition also triggers an automatic stay.[13] In Chapter 11 cases, however, generally no trustee is appointed, but the debtor himself stays in control of the operation of the business as 'debtor-in-possession'.[14] During the bankruptcy the debtor-in-possession may use, sell or lease property of the estate and obtain financing in the ordinary course of business.[15] The U.S. Trustee monitors the debtor-in-possession and the operating of its business. Furthermore, the U.S. Trustee appoints the members of the creditor committee and organizes a creditor meeting.[16]

After a bankruptcy petition is filed a debtor has the exclusive right to propose a reorganization plan during the first 120 days.[17] This 'exclusivity period' may be extended up to a maximum of 18 months.[18] After the exclusivity period has expired any party in interest may propose a plan.[19] The Bankruptcy Code states that the proposed plan has to designate classes of claims and interests for treatment.[20] The proponent of a plan is free in the classification of the creditors in the different classes, but within a class each claimant has to be treated equal under the plan. [21]

The proponent of a reorganization plan must not only provide the court with the plan itself, but also with a disclosure statement. This disclosure statement has to provide creditors with

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[7] This petition may be either voluntary or involuntary. See: 11 USC § 301(a) and 303(b).
[8] 11 USC § 362. See 11 USC § 362 (b) for exception on the automatic stay.
[9] 11 USC § 701 and 704. In Alabama and North Carolina the trustee is appointed by the bankruptcy court. The U.S. Trustee is part of the Department of Justice of the United States. If there are no assets or all assets of the debtor are exempted from liquidation a 'no asset' report will be filed with the court and no distribution to the creditor will take place. See: Federal Rule of Bankruptcy Procedure 5009.
[10] 11 USC § 726. Section 726 acknowledges six classes of claims. Each class of claims must be paid in full before a lower class can receive anything.
[11] This petition may also be either voluntary or involuntary. A Chapter 11 case may be qualified as a 'small business case' in the case of a small business debtor (11 USC § 101(51C)) or a 'single asset real estate' case if the debtor conducts no other substantial business than the operation of a single real estate property or project (11 USC § 101 (51B). In this Article no further attention will be devoted to the distinction between these cases.
[12] i.e. the restructuring of the liabilities of a debtor. A liquidating plan is also permissible under Chapter 11.
[13] 11 USC § 362.
[14] 11 USC § 1107(a). The bankruptcy court can appoint a trustee. It can also appoint an examiner. The role of the examiner is usually investigatory, but the court may grant the examiner broader powers. 11 USC § 1106.
[15] 11 USC § 363(c) and 364. Prior approval by a court is unnecessary, unless ordered otherwise.
[16] 11 USC § 341 and 1102. The creditor committee ordinarily consists of the unsecured creditors who hold the seven largest claims.
[17] 11 USC § 1121(b). 11 USC § 1123(a) and (b) list the mandatory and discretionary provisions of a reorganization plan.
[18] 11 USC § 1121(d). The exclusivity period may also be curtailed by the court.
[19] If a trustee is appointed he may file a plan. The U.S. Trustee may not file a plan (11 USC § 307).
[20] 11 USC § 1123(a)(1).
[21] There are some limits to the classification of creditors. According to the Fifth Circuit "[a] fair reading of [11 USC § 1122] suggests that ordinarily 'substantially similar claims', those which share common priority and rights against the debtor's estate should be placed in the same class." See: Phoenix Mutual Life Insurance Corporation v. Greystone III Joint Venture, 995 F.2d 1274 (5th. Cir. 1991).

‘adequate information’ with regard to the debtor, so creditors can make an informed decision on the plan.[22]

After the disclosure statement is approved by the court a vote takes place on the proposed reorganization plan or plans. If a creditor is not impaired by the reorganization plan he is deemed to have approved a plan and his consent is unnecessary.[23] Other creditors have the right to vote on the plan. Starting point for acceptance of a plan is that all classes have to consent to a plan in order for it to be eligible for confirmation.[24]

If not all impaired classes have voted in favor of a proposed reorganization plan the court can still confirm the plan on the basis of a ‘cram down’. A cram down is possible if at least one class of claimants votes in favor of the reorganization plan and the proposed plan does not discriminate unfairly and is fair and equitable with regard to the opposing classes.[25]

No unfair discrimination means that different groups with the same priority cannot be treated unequal, unless there is a valid reason.[26] In order for a plan to be ‘fair and equitable’ it has to meet the requirement of 11 USC § 1129 (b). With regard to secured creditors this section holds that a plan may be confirmed if a fully secured creditor opposing the plan retains his lien on the collateral to the extent of the value of the collateral and the creditor is paid, with interest, over the life of the plan, the amount of the allowed secured claim with interest.[27] With regard to unsecured creditors and shareholders the section provides that a plan may only be confirmed if a shareholder receives nothing or retains an interest until the unsecured creditors are paid in full.[28] This last rule is called the ‘absolute priority rule’ and ensures that shareholders do not receive payment before creditors are paid in full.

After all requirements are met the bankruptcy judge will confirm the reorganization plan and all creditors and the debtor are bound to it.[29] The confirmation of the plan also provides for a general discharge of all debts that arose before the date of confirmation.[30] This way the bankruptcy will come to an end.

2. Bankruptcy procedure in the Netherlands

The proposals discussed in this Article are all geared towards American bankruptcy law. This, however, is not the only existing system of bankruptcy law in the world. One could, for example, also look at Dutch bankruptcy law. The Dutch Bankruptcy Code (DBC) entered into force in 1896 and replaced the provisions regarding bankruptcy in the Code of Commerce of 1838 (*Wetboek van Koophandel*). Under the Dutch Bankruptcy Code two

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[22] 11 USC § 1125.
[23] 11 USC 1126(f). A class that is impaired by the plan, but does not receive anything is deemed to have voted against the plan. 11 USC § 1126(g).
[24] 11 USC §1129(a)(8). A class is deemed to have consented to the proposed plan if an amount of creditors representing two thirds of the amount impaired and half of the number of claims within the class has voted in favor of the proposed plan. 11 USC § 1126(c). In case of equity it is sufficient if the consenting shareholders represent two thirds of the amount of impaired equity capital. 11 USC § 1126(g).
[25] 11 USC § 1129(a)(10) and 1129 (b)(1). The requirements of 11 USC § 1129(a) should be met whether all classes have accepted the plan or not.
[26] 11 USC § 1129(b)(1).
[27] 11 USC § 1129(b)(2)(A)(i)(I). 11 USC § 1129 (b)(2)(A)(ii) states that a secured creditor has a right to an asset sale. A plan can also be confirmed if the secured creditor receives the ‘indubitable equivalent’ of his claim. 11 USC § 1129(b)(2)(A)(iii).
[28]1129 (b)(2)(B)(ii).
[29] 11 USC § 1141(a).
[30] 11 USC § 1141(d)(1).

insolvency procedures are available for corporate debtors: bankruptcy (*faillissement*) or suspension of payments (*surseance van betaling*).[31]

The bankruptcy of a debtor in the Netherlands starts with the filing of a petition with the court.[32] After the debtor has been declared bankrupt by the court, a trustee (*curator*) will be appointed.[33] The debtor-in-possession does not exist under Dutch bankruptcy law, but the trustee can keep management in place.[34] The trustee is supervised by a supervisory judge (*rechter-commissaris)* and will need approval from this judicial officer for most acts of administration.[35] Usually no creditor committee is appointed, although the law provides for the possibility of installing one.[36]

Dutch bankruptcy law provides for an automatic stay, although secured creditors can still enforce their claims. [37] This last possibility of individual debt collection can be prevented if the supervisory judge proclaims a cooling-off period (*afkoelingsperiode*).[38] This cooling-off period has a duration of two months and can be extended once by two more months.

The starting point of a Dutch bankruptcy procedure is liquidation. This means that - like a Chapter 7 procedure - the trustee will sell all assets of the debtor, either piecemeal or going-concern, and the proceeds are distributed among the creditors according to their relative priority. Unlike in the United States Dutch bankruptcy law has no separate reorganization procedure for which a debtor can file. It is, however, possible for the debtor to propose a reorganization plan (*faillissementsakkoord*) to the creditors during the bankruptcy procedure.[39] This possibility is reserved exclusively for the debtor. Proposal of a reorganization plan by the trustee or a creditor is not possible. Furthermore, shareholders and creditors with a right of preference are not bound to a reorganization plan.[40] As such Dutch law does not know an explicit absolute priority rule.

A proposed reorganization plan is accepted if more than half of the acknowledged and conditionally acknowledged ordinary creditors that are present at the meeting of creditors, representing at least half of the total amount of ordinary claims, approve.[41] Creditors do not vote in classes. If the previously mentioned requirements are not met the supervisory judge can still cram down the proposed plan if three fourths of the acknowledged and conditionally acknowledged creditors present at the meeting of creditors have approved of the proposed plan and the rejection of the plan is the consequence of unreasonable voting behavior.[42]

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[31] Bankruptcy is laid down in § 1–213kk DBC; suspension of payments in § 214-283 DBC. Suspension of payments is meant as a temporary solution for an acute liquidity problem. It provides, as the name implies, for a suspension of payments. This procedure will not be further discussed in this Article. However, some judgments that are discussed hereinafter have been pronounced during a suspension of payments procedure. Since the procedure for a reorganization plan under a suspension of payments procedure is (almost) equal to the procedure for a reorganization plan in a bankruptcy these judgments can also be applied in a bankruptcy situation.
[32] This petition can be filed either voluntarily or involuntarily. §1 DBC.
[33] § 14 DBC.
[34] Management, however, will have to follow instructions from the trustee. Furthermore, this construction is seldom used in the Netherlands.
[35] § 64.
[36] § 74 and 75 DBC. A creditor committee can consist of a maximum of three members.
[37] §33; 57 DBC and 3:248 and 3:268 DCC.
[38] § 63a DBC.
[39] § 138 DBC.
[40] § 157 DBC.
[41] § 145 DBC.
[42] § 146 DBC.

After a debtor has proposed a reorganization plan there is no requirement to file a disclosure statement. The trustee, however, - and the creditor committee if one is appointed – has an obligation to provide the creditors with written advice with regard to the proposed reorganization plan.[43] After this advice has been given creditors vote on the proposed plan in a meeting of creditors. Since creditors with a right of preference and shareholders, unlike in the United States, are not bound to the reorganization plan, they are not eligible to vote on the reorganization plan.[44]

If the proposed plan is approved by the creditors or crammed down, the court will hold a confirmation meeting (*homologatiezitting*). The Dutch Bankruptcy Code contains four provisions that provide for an imperative ground for refusal of confirmation and one discretionary ground.[45] One imperative provision states that the assets of the estate may not substantially exceed the amount of assets included in the reorganization plan.[46] Another provision states that confirmation has to be refused if the execution of the reorganization plan is not safeguarded enough.[47]

After the plan is confirmed the reorganization plan is binding on all creditors with a right to vote, even if creditors have not voted or have not submitted their claims for verification. The debtor is discharged of all debts affected by the reorganization plan and the bankruptcy comes to an end.

Part B

1. The administrative reorganization procedure

1.1 The administrative reorganization procedures

In part A an overview of the American Chapter 11 procedure and the Dutch *faillissementsakkoord* were given. Both procedures are an example of an administrative reorganization procedure. In such a procedure claimants and the debtor bargain in a way that is structured by the law. This kind of bargaining involves a 'hypothetical sale' of the debtor. This means that the liabilities of the debtor are sold to the existing claimants for a price lower than the amount of the outstanding claims. This way the debtor is reorganized.[48] The idea is that such a hypothetical sale is efficient, because the debtor is worth more in the hand of the existing claimants than outside parties.[49] In other words, a reorganization preserves the 'going-concern value' of the debtor. This is the value that is inherently linked to the continuation of a distressed corporation.

The result of the bargaining is what parties agree to be the value of the debtor. This value is then laid down in a reorganization plan, which is voted on by the creditors. If a certain number of creditors consent to the reorganization plan, it is confirmed or denied confirmation

[43] § 140 DBC.
[44] § 143 and 157 DBC. I note that shareholders are often not eligible to vote on a proposed plan in the U.S. either. However, this is because they do not receive or retain any interest in the debtor under the plan and are, thus, presumed to reject it. See: 11 USC § 1126 (g).
[45] § 153 DBC.
[46] § 153(2)(1) DBC.
[47] § 153(2)(2) DBC. This rule can roughly be compared to the American feasibility test.
[48] It is also possible to liquidate a corporation under an administrative reorganization procedure.
[49] The U.S. Supreme Court has affirmed that "Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap'". United States v. Whiting Pools, Inc. 462 U.S. 198, 203 (1983).

by a judge. In this respect the judge is thought to be the most suitable party to determine the value of a corporation.

1.2 Costs of an administrative reorganization procedure

However, criticism with regard to the administrative reorganization procedure has been expressed over the years. Especially the U.S. Bankruptcy Code and Chapter 11 have been criticized. Several authors have argued that existing U.S. bankruptcy law is inefficient. They argue that it should be modified or even repealed and replaced by another kind of procedure. Criticism against Chapter 11 has mostly been directed at four specific points: i) valuation of assets, ii) (direct) costs, iii) speed, and iv) perverse incentives.[50]

In order to be able to make a valid comparison between the administrative reorganization procedure and the proposed alternatives it is necessary to set out the argument made by the different authors with regard to the costs of an administrative reorganization procedure. This section aims to do so. These costs can then be weighed against the alternatives for the administrative reorganization procedures that will be discussed in the following sections.

1.2.1 Valuation uncertainty

As stated above, an administrative reorganization procedure involves a hypothetical sale of a corporation. This means that the parties involved do not have a fixed figure with regard to the value of the reorganized company.[51] These parties reach a value of the corporation by means of negotiation. In order for a reorganization to be efficient, however, a corporation has to be correctly valued.[52]

From a normative point of view a correct valuation is necessary to ensure that no wealth is redistributed in the bankruptcy of the debtor. No wealth redistribution means that the order or relative priority is respected in bankruptcy. [53] Or, in other words, that there has to be absolute priority. Otherwise the claimants in the bankruptcy receive either too small or too big a part of their claim compared to the situation in which the real value of the reorganized company would be known.

In the event of a reorganization a valuation of a debtor will also be necessary from the point of view of positive law. Under U.S. law, as set out above in § 1 of Part A, a plan has to be 'fair and equitable', otherwise a judge cannot cram down a reorganization plan over the objection of a dissenting class. The requirement of being fair and equitable entails absolute priority for the creditors and shareholders of the debtor.[54] As explained above, to ensure this absolute priority a valuation of the corporation will have to take place.[55] Furthermore, the assets that serve as collateral for secured claims have to be valued. Not only to determine the

[50] See Part C.3 for a discussion whether these criticisms are (compeletely) justified.
[51] This problem does not exist in the event of a liquidation, because an actual sale takes places and there is an indisputable figure what the value of the company is.See for an example of the valuation problem: Bittner v. Borne Chem. Co., 691 F.2d 134, 135-137 (3d Cir. 1982).
[52] This section only deals with valuation of the assets of the debtor. The administrative reorganization procedure as well as other proposals discussed in this Article have little to say about valuation of the claims of the debtor.
[53] Thomas H. Jackson, *Of liquidiation, continuation and delay: an analysis of bankruptcy policy and nonbankruptcy rules,* 60 Am. Bankr. L.J. 399, 406, (1986A).
[54] 11 USC § 1129 (b).
[55] See also: Douglas G. Baird and Donald S. Bernstein, *Absolute priority, valuation uncertainty, and the reorganization bargain*, 115 Yale L.J. 1930, 1935 (2006).

entitlements of the secured creditors, but also because of debtor-in-possession financing.[56] Such financing is only possible if the existing lien holders are 'adequately protected'.[57] A valuation of the collateral will have to take place to determine whether existing lien holders are protected and how much room is left for a priming lien.[58]

Under Dutch law a valuation of the bankrupt debtor is also necessary. For example, under § 153 (2)(1) DBC the judge will have to deny confirmation of a proposed reorganization plan if the assets of the estate substantially exceed the proposed pay-out under the reorganization plan.[59] According to the Supreme Court of the Netherlands this provision holds that a judge should make an arithmetic comparison between the assets of the estate and the proposed pay-out and no more than that.[60] In light of § 153 (2)(1) DBC the judge will have to value the assets of the debtor to be able to establish whether the proposed plan satisfies the legal requirement imposed by that provision.[61]

Reorganizing a debtor under an administrative reorganization procedure therefore involves a valuation. There are, however, several impediments to a correct valuation of a debtor. First of all, because there is no fixed value, parties can advance only an estimate of the valuation of the bankrupt debtor. In advancing this estimate senior creditors have an incentive to argue for a low valuation of the debtor, for this provides them with a bigger part of the corporation. Junior creditors on the other hand have an incentive to advance a high valuation, because the higher the valuation the higher the pay-out to these creditors.[62]

Besides strategic incentives other impediments that come into play in regard to correctly valuing the debtor are 'actual uncertainty' and 'judicial valuation uncertainty'.[63] Actual uncertainty is uncertainty regarding the factual value of a corporation. Parties usually aim to diminish this kind of uncertainty by hiring an expert to perform a valuation of the bankrupt corporation by means of an accepted valuation method.[64] These valuation methods, however, still result in only an educated guess. Moreover, the valuations are submitted by parties involved in the bankruptcy. These parties are biased.[65] And even if the real value of a corporation can be established, it remains to be seen if the judge accepts the established value. It may be that the judge is biased either pro-debtor or pro-creditor and that this bias skews the valuation of the debtor.[66] It may also be that the judge simply does not possess the necessary skills to value the debtor.[67]

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[56] Lucian A. Bebchuk and Jesse M. Fried, *A new approach to valuing secured claims in bankruptcy,* 114 Harvard L. Rev 2386, 2388 (2001).
[57] 11 USC § 364 (d)(1)(B).
[58] This problem does not arise when the pre-bankruptcy lender and the debtor-in-possession lender are the same.
[59] § 153 (2)(1) DBC states: *"Zij zal de homologatie weigeren indien de baten des boedels, de som, bij het akkoord bedongen, aanmerkelijk te boven gaan."* With regard to the assets it should be noted that it is probable that under Dutch law a judge should take the going-concern sale of the assets into account in assessing the value. See: Court of Appeal Leeuwarden 21 July 2006, LJN AY4796
[60] Supreme Court 24 November 2006, NJ 2007, 239.
[61] B. Wessels, Het akkoord 53 (3rd ed. 2010).
[62] K. O'Rourke, *Valuation uncertainty in Chapter 11 reorganization,* 2005 Colum. Bus. L. Rev 403, 432.
[63] O'Rourke 2005, p. 414-415.
[64] The most common valuation methods are Discounted Cash Flow, the Market Comparison and Precedent Transaction.
[65] O'Rourke 2005, p. 427.
[66] Keith Sharfman, *Judicial valuation behavior: some evidence from bankruptcy,* 32 Fla. St. U. L. Rev. 387, 390 (2005) and literature cited there.
[67] O'Rourke 2005, p. 448-449. A related complication is that a judge usually decides on the basis of information provided to him by the parties. This information may also be biased. See: Baird and Bernstein 2006.

A final complication for the parties negotiating over the value of the debtor and the judge determining this value is that the value of the debtor may change during the bankruptcy. The first source of this change of value is that parties may seek to delay negotiations to create nuisance value and that, as a result, the debtor incurs more direct costs. A second source of these costs is the depreciating value of the debtor as a result of foregone investment opportunities and continuing uncertainty with regard to the future of a corporation.

In short, a hypothetical sale can therefore lead to an incorrect valuation. The proposals for a Chameleon and Contingent Equity corporation, options-theory and the proposal for mandatory auctions are all aimed at solving the valuation problem.[68]

1.2.2 Direct costs

The criticisms on bankruptcy law discussed in this Article are also directed at the contended direct costs of an administrative reorganization procedure. The different authors argue that the process of a Chapter 11 bankruptcy can take a very long time and that such a drawn-out procedure is highly costly. They further argue that a lot of costs involved with Chapter 11 are caused by the use of a multitude of professionals involved in the reorganization process and that their proposals will diminish the direct costs of bankruptcy.

Of course, the starting point is the lower the direct costs of an insolvency procedure, the better. It will, however, be very hard - if not impossible - to conduct a costless insolvency procedure. Therefore, the real question is whether an administrative reorganization procedure is disproportionally costly in comparison to alternatives.

There are several kinds of direct costs related to an administrative reorganization procedure. For a Chapter 11 procedure the starting point is that all professionals paid out of the estate need to be approved.[69] These professionals usually include attorneys (debtors counsel) and financial advisors. At the end of the procedure most of these professionals also have to have their requested compensation approved by the court.[70] Furthermore, the estate has to pay for the expenses of professionals hired by court appointed creditor committees.[71] Of course, if a trustee or examiner is appointed his fees also have to be reimbursed.[72] Other direct costs of an administrative reorganization procedure are, for example, court filing fees and the quarterly fees due to the United States Trustee.

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[68] Barry E. Adler, *Financial and political theories of American corporate bankruptcy,* 45 Stan. L. Rev. 311 (1993); Barry E. Adler, *Finance's theoretical divide and the proper role of insolvency rules,* 67 S. Cal. L. Rev 1107 (1994A); Barry E. Adler, *a theory of corporate insolvency,* 72 N.Y.U. L. Rev. 343 (1997); Michael Bradley and Michael Rosenzweig, *The untenable case for Chapter 11,* 101 Yale L.J. 1043 (1992); Lucian A. Bebchuk, *A new approach to corporate reorganizations,* 101 Harv. L. Rev. 775 (1988); Lucian A. Bebchuk, *Using options to divide value in corporate bankruptcy, 44 Eur. Econ. Rev. 829 (* 2000); Philippe Aghion, Oliver Hart and John Moore, *The economics of bankruptcy reform,* 8 J. of L., Econ. & Org. 523 (1992); Philippe Aghion, Oliver Hart and John Moore, *Improving bankruptcy procedure,* 72 Wash. U. L.Q. 849 (1994); Oliver Hart, Rafael La Porta Drago, Florencio Lopez-de Silanes en John Moore, *A new bankruptcy procedure that uses multiple auctions,* 41 Eur. Econ. Rev. 461 (1997); Douglas G. Baird, *The uneasy case for corporate reorganizations,* 15 J. of L. Studies 127 (1986) and Douglas G. Baird, *Revisiting auctions in Chapter 11,* 36 J. of L. and Econ. 633 (1993). It is noted that these proposals are not directed at solving the valuation problem in relation to collateral for secured claims.

[69] 11 USC § 327(a).

[70] 11 USC § 330 and 331.

[71] 11 USC § 330. See about the hiring of professionals hired by creditor committees in Chapter 11 bankrupticies 11 USC § 1103 (a).

[72] 11 USC § 330.

For Dutch law the starting point is that there is always a court appointed trustee.[73] His fees are to be paid from the estate. However, the Association of Supervisory Judges in Bankruptcies (Recofa) has drawn up guidelines that set out the maximum hourly fees for trustees.[74] Furthermore, the trustee can retain attorneys and professionals on behalf of the estate with the consent of the supervisory judge. These professionals are usually accountants. The attorneys hired by the trustee generally are not involved in the reorganization itself, but rather in pending litigation against the debtor. Their fees are not limited, but are subject to approval by the supervisory judge based on the Recofa Guidelines.[75] Furthermore, the appointment of a creditor committee is possible, but is an exception. This is usually only done in very large cases. The expenses of the creditor committee have to be reimbursed by the estate, but only insofar as they are 'necessary' and approved by the supervisory judge.[76] The amount of the costs incurred by the creditor committee – if appointed – is usually limited.

1.2.3 Speed

Another factor that is often cited as being relevant for the efficiency of the administrative reorganization procedure is the length of the procedure. The argument is quite simple: the longer the procedure, the higher both the direct and indirect costs.[77] The argument with regard to the direct costs has been set out in the preceding section. The idea behind the argument with regard to the indirect costs is that managers and shareholders of an unviable firm wish to postpone a liquidation in hope of turning the company back into solvency. And such postponement of a liquidation costs money. An example that is often cited by critics of Chapter 11 is the bankruptcy of Eastern Airlines in the late eighties of the previous century.[78] In this bankruptcy Eastern Airlines was allowed to continue operations long after they should have been terminated. As a result the creditors received a substantially lower pay-out than if the company had been liquidated at the start of the bankruptcy procedure.

1.2.4 Perverse incentives for management

A final element of criticism that has been directed at Chapter 11 and is discussed in this Article are the contended perverse incentives for management. Such perverse incentives can arise because of agency problems, which in turn are related to the reason firms exist. This reason, so it is generally acknowledged, is the existence of transaction costs.[79] Transaction costs are the costs incurred by someone when using the market to exchange goods. For example, if someone wants to buy a car he will incur certain costs. Ex ante he will have to incur costs to establish a contract. In case of a car the buyer has to search for someone who has the car the buyer wants. He also has to inform himself about the mechanics of the car, so he can assess the technical condition of the car. Ex post the buyer will incur costs to enforce

[73] § 14 DBC.
[74] In practice these guidelines are almost always observed.
[75] § 28 Recofa Guidelines.
[76] G.W. van der Feltz, Geschiedenis van de Wet op het faillissement en de surseance van betaling II 20 (1st ed. 1897).
[77] Karin S.Thorburn, *Bankruptcy auctions: costs, debt recovery, and firm survival,* 58 2000 337, 339 and Lynn M. LoPucki and Joseph W. Doherty, *The determinants of professional fees in large bankruptcy reorganization cases,* 1 2004 111, 113.
[78] See about this bankruptcy: :Lawrence A. Weiss and Karen H. Wruck, *Information problems, conflicts of interest, and asset stripping: Chapter 11's failure in the case of Eastern Airlines,* 48 J. of Fin. Econ. 55 (1998).
[79] This idea was first developed by Ronald Coase in his piece 'The nature of the firm'. See: Ronald.H. Coase, *The Nature of the Firm,* 4 Economica 386 (1937).

the contract. An example of such costs are those made to enforce a warranty provided for in the contract.

If the costs of producing the same good within a firm are lower than the costs of 'producing' the good via the market (i.e. the transaction costs), a firm will be established. If one recognizes that a firm is a 'nexus of contracts', then the costs of producing a good within a firm can be described as the costs incurred in relation to these contracts.[80] Jensen and Meckling have argued that one of the most important forms of these costs are agency costs, which are the result of the agency problem. The agency problem is the problem that arises in situations of agency relationship. This is when one person (the 'agent') performs some kind of task for another person (the 'principal').[81] Because the agent is assumed to be a rational actor, he will not always act in the best interest of the principal. This is made possible by the fact that, generally, the agent has better information than the principal. Thus, it is difficult for the principal to control whether the agent is acting in his (the principal's) best interest.[82]

These agency problems come into play in a corporate context. In this respect it is relevant that corporations are formed because it provides for the separation of ownership (shareholders) and control (managers). This separation provides for an opportunity of specialization. Shareholders provide capital and bear risk and managers can use their knowledge to invest the provided capital.[83] However, this separation of ownership and control, seen as an agent-principal relationship, also causes agency problems.[84] This is not surprising. The managers are (at least in part) hired to establish value for the shareholders, but remain rational self-interested people.[85] Because of agency costs a governance regime is put into place to limit the amount of perverse incentives for management. This governance follows from relevant provisions in the law, contractual covenants and market discipline.

Under American law, management of the debtor continues to be in charge of the corporation after it has been declared bankrupt.[86] This continuation of management power also provides for continuation of agency problems in a bankruptcy context.

The debtor-in-possession structure was introduced because, according to Congress, this would lead to a timely filing for bankruptcy by management, since they would retain their jobs under the reorganization procedure. This, in turn, would prevent unnecessary liquidations.[87] Furthermore, since management was already well acquainted with the

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[80] The term 'nexus of contracts' was coined by M.C. Jensen and W.H. Meckling. See: Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, (1976). However, Alchian and Demsetz already described the firm as a 'contractual form'. See: Armen A. Alchian and Harold Demsetz, *Information costs, and economic organization,* 62 Am. Econ. Rev. 777, 778 (1972). Armour, Hansmann and Kraakman write about a 'nexus *for* contracts'. See: J. Armour, H. Hansmann and R. Kraakman, in: Kraakman et al., The anatomy of corporate law 6 (Reinier Kraakman et al. eds., 2nd ed. 2009). For the purpose of this Article this does not make a real difference.

[81] The seminal piece on agency theory is written by M.C. Jensen and W.H. Meckling. See: Jensen and Meckling 1976. See also: Eugene F. Fama, *Agency problems and the theory of the firm,* 88 J. of Pol. Econ. 288 (1980) and Eugene F. Fama and Michael C. Jensen, *Agency problems and residual claims,* 26 J. of L. and Econ. 327 (1983).

[82] J. Armour, H. Hansmann and R. Kraakman, in: Kraakman et al. 2009, p. 35-36.

[83] Alan J. Meese, *The team production theory of corporate law: a critical assessment,* 43 Wm. & Mary L. Rev. 1629, 1630 (2002).

[84] Jensen and Meckling 1976, p. 86.

[85] Whether managers are hired purely to create shareholder value or should pursue stakeholder value is a separate discussion. However, for now the important point to note here is that in both conceptions managers are the agents of the shareholders as principals.

[86] 11 USC § 1107(a).

[87] H.R. REP. NO. 595, 95th Cong., 1st Sess. 233 (1978)

corporation, it would be more capable of leading it through the reorganization process.[88] Finally, retaining management as debtor-in-possession would save the costs of a trustee.[89]

However, according to Adler as well as Bradley and Rosenzweig the debtor-in-possession structure may give a perverse incentive to management to file for reorganization rather than liquidation even if the latter is more efficient. They are worried that because of this the debtor-in-possession structure makes the reorganization process of Chapter 11 pro-debtor and inefficient.

Adler argues that unnecessary costs arise in an administrative procedure, because pre-bankruptcy management controls both the corporation and the reorganization process.[90] Control of the corporation flows from the fact that the debtor remains in possession during bankruptcy; control of the process flows from the fact that the debtor has an exclusive right to file a plan of reorganization.[91] Because of this, control management would be able to extract concessions from creditors who would want to minimize the length of the reorganization process and the costs involved with the reorganization.[92] Creditors would also give in to management, because they fear that management would take unjustified risks with the debtor's assets in an attempt to make the corporation solvent again.[93] Because creditors anticipate that the aforementioned costs would be made they would incur extra costs with regard to monitoring the debtor prior to bankruptcy in an attempt to protect their interests.[94]

Bradley and Rosenzweig also contend that perverse incentives for managers exist under Chapter 11. According to Bradley and Rosenzweig these perverse incentives are present because managers would have a strong preference for reorganization of a corporation over liquidation. The reason being that managers continue to control the corporation during bankruptcy and have a bigger chance of retaining their job once the corporation is reorganized.[95] Just as Adler they argue that because management remains in control during bankruptcy it would be encouraged to take unduly risks and burden the corporation with excessive debts.[96] And, when management is seen as the agent of shareholders, management has an incentive to try and reorganize a corporation rather than liquidate it, because this way shareholders retain an interest in the corporation.[97]

2. Ex ante capital structures

Now that the administrative reorganization procedure has been discussed, we have some reference for discussing the proposals described in this section. The first alternative for the

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[88] H.R. REP. NO. 595, 95th Cong., 1st Sess. 235 (1978)
[89] H.R. REP. NO. 595, 95th Cong., 1st Sess. 233 (1978)
[90] Adler 1993A, p. 315.
[91] See: 11 USC § 1107 (a) and 1108 for the debtor-in-possession. 11 USC §1121 gives the debtor the exclusive right to file a reorganization plan for 120 days after the order for relief. This point is also made by LoPucki. See: LoPucki 1993, p. 692.
[92] Barry E. Adler, *Bankruptcy primitives,* 12 Am. Bankr. Inst. L. Rev. 219, 220 (2004).
[93] Adler 1993A, p. 316.
[94] Adler 1993A, p. 317.
[95] Bradley and Rosenzweig 1992, p. 1045. See: 11 USC § 1107 (a) and 1108 for the debtor-in-possession. Management also has control over a corporation, because once in bankruptcy creditors can no longer exercise their individual rights of debt collection. See: 11 USC §362. Bradley and Rosenzweig explicitly leave aside the question whether operation of a corporation by a trustee might also remove the problem of management. See: Bradley and Rosenzweig 1992, p. 1086, fn. 101.
[96] Bradley and Rosenzweig 1992, p. 1047.
[97] Bradley and Rosenzweig 1992, p. 1051. Management can, for example, overstate the value of the corporation, thus prompting a reorganization, which would leave the shareholders with an interest in the corporation.

administrative reorganization procedure is the ex ante capital structure. An ex ante capital structure is a contractual structure that, according to several authors, would form an efficient replacement for the U.S. Bankruptcy Code or at least Chapter 11.[98] Hereinafter three proposals for this kind of capital structure are discussed and assessed. These proposals are: the Chameleon Equity proposal by Adler, the Contingent Equity solution by Bradley and Rosenzweig and the menu approach as advocated by Rasmussen.[99]

2.1 Chameleon Equity

Professor Adler has argued that – if no legal impediments existed – investors would implement a contractual structure that would prevent the need for bankruptcy law with regard to corporate reorganizations.[100] This contractual structure would be more efficient than an administrative procedure, because the contractual structure would cost less.[101]

As described in § 1.2.4., Adler contends that perverse incentives exist for management under the current reorganization procedure. Adler further argues that an administrative reorganization procedure is inefficient because of the valuation problem that exists when a hypothetical sale takes place. To eliminate the valuation problem, and to prevent the arising of the costs incurred because of perverse incentives for management, Adler proposes to introduce a contractual structure by the name of Chameleon Equity.[102]

2.1.1 The Chameleon Equity structure

The basic idea behind a corporation that is structured on the basis of Chameleon Equity is that the corporation would not issue debt, but only fixed obligations by the name of Chameleon Equity obligations.[103] These fixed obligations would provide the holder with the same rights to payments from a corporation, but the law would eliminate the possibility to collect individually if a corporation defaults on its obligations.[104] Thereby eliminating a potential 'race to the courthouse'.[105]

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[98] All proposals are limited to corporate debtors. Adler seems to argue for the abolishment of Chapter 11. Bradley and Rosenzweig argue that all form of court supervised reorganizations should be abolished. See: Bradley and Rosenzweig 1992, p. 1078. The proposal by Rasmussen aims to replace current bankruptcy law. Both Adler as well as Bradley and Rosenzweig take the Chapters 7 and 11 of the U.S. Bankruptcy Code as a reference. Whether their arguments are also valid under Dutch law is discussed below in Part D.

[99] Adler 1993A; Barry E. Adler, *A world without debt,* 72 Wash. U. L.Q. 811 (1994B), Adler 1994A; Adler 1997; Bradley and Rosenzweig 1992 and Robert K. Rasmussen, *Debtor's choice: a menu approach to corporate bankruptcy,* 71 Tex. L. Rev. 51 (1992).

[100] Adler 1993A, p. 311 and Adler 1997, p. 351. The main legal impediments Adler notes are: the inability to waive management's right to file for bankruptcy (11 USC § 301), the deductibility of interest, but not of dividend payments (26 USC § 163 (a)), the inability to prevent management from issuing traditional debt and the ability of nonconsensual claimants to seek individual recourse against a debtor. See: Adler 1993A, p. 334-340 and Adler 2004, p. 223. Lubben argues that these impediments are already a clear indicator that Adler's theory is not viable. Stephen J. Lubben. *Some more realism about reorganization: explaining the failure of Chapter 11 theory,* 106 Dick. L. Rev. 267, 285 (2001). Tabb is also critical of changing tax, corporate and commercial law to facilitate Adler's proposal. See: Charles J. Tabb, *Of contractarians and bankruptcy reform: a skeptical view,* 12 Am. Bankr. Inst. L. Rev. 259, 267 (2004).

[101] Adler 1993A, p. 312.

[102] Adler 1997, p. 351-352. Adler is unclear about why it is insufficient to simply amend current bankruptcy law.

[103] Adler 1993A, p. 323. A Chameleon Equity corporation would still have a residual class of traditional shareholders.

[104] Adler 1994B, p. 816.

[105] If there was only an individual system of debt collection when a debtor was insolvent, debts would be paid on a 'first come, first serve' base. Therefore, if there is not enough to repay every creditor, only the creditors

The Chameleon Equity obligations would be issued in tranches that differ in priority. If a corporation is unable to meet its obligations the class of creditors which obligations the corporation is unable to meet would transform into traditional equity – thus decreasing the amount of debt of the corporation - and the former class of shareholders would be wiped out.[106] The new traditional equity class would then have voting power over the corporation and would be able to decide whether they would want to liquidate or continue the corporation.[107] The other bond holders would remain unaffected and the corporation would still have to pay its fixed obligations to them. This, however, would not be a problem anymore, because the corporation has been transformed - without a bankruptcy process - from an insolvent corporation into a solvent corporation again.[108] So, Adler argues, the introduction of the Chameleon Equity corporation would prevent the arising of the common pool problem, while at the same time providing for a reorganization method that is more efficient than the administrative procedure.

2.1.2 The Chameleon Equity structure elaborated

Adler discusses several specific points in relation to the Chameleon Equity structure to show how it works. For example, Adler argues that in a Chameleon Equity corporation it would be prohibited to issue fixed obligations with acceleration-on-default clauses for classes that could survive the transformation of a lower class.[109] In a traditional corporation, acceleration-on-default clauses accelerate payment when a default occurs. This prevents opportunistic behavior by shareholders for a shareholder threatened with a default that would trigger an acceleration-on-default clause has an incentive to generate just enough capital to remain the residual claimant of the corporation. He will most likely try to generate this capital by risky investments. This preference for high-risk investment stems from the fact that without it the shareholders are likely to lose their status as residual claimants because of the default.[110]

In a Chameleon Equity corporation, however, default triggers the transformation of the lowest priority class of fixed obligations into equity. Unaffected classes therefore have no need for acceleration because this new equity class - of a solvent corporation - would risk its own investment and, accordingly, has no incentive to invest in risky projects.[111] So, the goal of an acceleration clause is already achieved. To minimize perverse incentives in case a corporation is still insolvent after its transformation, high-priority classes should, according to Adler, require a corporation to have a relatively large percentage of low priority claimants.

Furthermore, Adler contends that a Chameleon Equity corporation would still be able to accommodate secured financing.[112] Collateral would only be offered to the highest-priority consensual claimants. As long as this class would not become the residual class, the need for collateral would prove unnecessary, since disputes among the secured creditors would not arise. If, and only then, the highest priority class of consensual claimants did become the

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who come early will be repaid. This leads to a situation in which creditors will try to be the first to seek recourse, because only then will they have a chance of being repaid in full.

[106] Adler 1993A, p. 324; Adler 1994B, p. 816 and Adler 1997, p. 352.

[107] Adler 1993A, p. 324. Furthermore, they would have to decide whether they would want to keep current management in place.

[108] In the example given, transformation of one class of obligation holders is sufficient to let the corporation return to solvency. In practice, of course, it could be necessary to transform more than one class. When no class can be transformed the corporation will have to be liquidated. This would signal not only financial distress, but also economic failure. Adler 2004, p. 223.

[109] Adler 1993A, p. 325.

[110] Adler 1993A, p. 325.

[111] Adler 1993A, p. 325.

[112] Adler 1993A, p. 327 and Adler 1994B, p. 819-821.

residual class they would be able to foreclose on their collateral and receive payment on their claim.

2.2 Contingent Equity

Around the same time as Adler's Chameleon Equity corporation proposal was published Bradley and Rosenzweig launched their idea for the introduction of the Contingent Equity corporation.[113] In their proposal Bradley and Rosenzweig argue that judges are inefficient in determining the value of a corporation and that valuation of a corporation should be done by the market and that perverse incentives for management exist. The Contingent Equity corporation would supposedly eliminate these incentives.[114] Furthermore, Bradley and Rosenzweig argue that their proposal would eliminate the deadweight costs of bankruptcy significantly.[115]

In light of the efficiencies mentioned above Bradley and Rosenzweig argue that Chapter 11 should be repealed and all forms of administrative reorganization procedures abolished.[116] Furthermore, a law should be enforced that provides for the automatic cancellation of the interests of shareholders in the event of default by a corporation.[117] In return, Contingent Equity shares would be introduced.

The proposal is as follows. Corporations would continue to issue traditional debt. Whether it be junior, mezzanine or senior. Furthermore, the traditional class of shareholders would still exist. All debt holders, however, would receive one Contingent Equity share for every unit of currency that is lent.[118] These Contingent Equity shares are contingent shares – hence the name – and would not have any role to fulfill until the corporation defaults on its obligations.

If the corporation defaults – and does not pay its obligation to its debt holders – the claims of the traditional shareholders would be automatically cancelled. A default occurs if the amount currently due to the debt holders is higher than the value of the equity.[119] Bradley and Rosenzweig argue that this situation would occur when the corporation were unable to place new equity in the market, because in such event investors apparently hold the opinion that an additional residual claim would hold no value.[120] This way the market decides the value of the corporation and whether there is a net equity position that justifies prevention of a default.[121] This ensures that management – as agent of the equity class – will try to avoid a default rather than pursuing risky investment strategies that have a high chance of inducing

[113] Bradley and Rosenzweig 1992.
[114] Bradley and Rosenzweig 1992, p. 1047 and p. 1050. See: David A. Skeel, *Markets, courts and the brave new world of bankruptcy theory,* 1993 Wis. L. Rev. 465, 475-476.
[115] Bradley and Rosenzweig 1992, p. 1050. These are the direct costs of a reorganization procedure, such as legal, accounting and advisory fees.
[116] Bradley and Rosenzweig 1992, p. 1078. They do not explain what influence their proposal would have on commercial, corporate or tax law. See: Donald R. Korobkin, *The unwarranted case against corporate reorganizationts: a reply to Bradley and Rosenzweig,* 78 Iowa L. Rev. 669, 717 (1993).
[117] Bradley and Rosenzweig 1992, p. 1078.
[118] So, one million Contingent Equity shares would be given to a lender that lends one million. Whether it be Euros, U.S. Dollars or any other currency.
[119] Bradley and Rosenzweig 1992, p. 1082.
[120] Bradley and Rosenzweig 1992, p. 1082.
[121] Bradley and Rosenzweig 1992, p. 1082. According to Bradley and Rosenzweig market participants would continually assess the value of the outstanding shares and contingent shares. Bradley and Rosenzweig 1992, p. 1085.

default, since all claims of traditionally shareholders are cancelled.[122] Thus removing a contended inefficiency of bankruptcy procedure.

Another consequence of a default would be that the lowest ranking class of debt holders would lose their right to get their outstanding claim paid. At the same time their contingent shares would be transformed into traditional equity and they would effectively become the new residual class of shareholders.[123] Now the new class of shareholders has to decide whether to default again or pay the amount currently due to the debt holders.[124] Again this decision will be made by the market, since raising the capital necessary to pay the debt holders will require the issuance of new equity.[125] This process would repeat itself until a class of shareholders can issue enough equity to pay the creditor or – if the senior creditors class is reached – the creditors can decide to either run the corporation, sell its equity to outside investors or liquidate the corporation.[126] No judicial intervention would be involved.

1.3 The difference between Chameleon Equity and Contingent Equity

The alert reader will have noticed that there is one major difference between the Chameleon Equity structure and the Contingent Equity structure: the possibility to seek individual recourse.

Adler admits that a common pool problem exists when a debtor defaults and therefore in his proposal the possibility to seek individual recourse is eliminated.[127] According to Adler this would solve the common pool problem. Individual debt collection rights, however, are not only relevant when a debtor cannot pay his debt, but also when a debtor plainly refuses to pay his debt; even if he is able to. In this last situation individual debt collection is very useful. It ensures that a solvent debtor will follow through on his obligations and cannot randomly refuse payment. For this reason it is doubtful whether all creditors would deem it sufficient to receive Chameleon Equity obligations without the possibility of individual debt collection.[128]

Furthermore, it is questionable whether the common pool problem would really be eliminated by introducing the Chameleon Equity structure and removing the possibility for individual debt collection. This removal may prevent the involuntary liquidation of the corporation, but it exacerbates the risk of voluntary liquidation. Since the equity class will lose everything on default, they will fervently try and avoid this from happening. For example, by selling the assets of the corporation piecemeal to generate money, thus avoiding a default.[129] Bradley and Rosenzweig have acknowledged this risk of asset substitution. They, however, argue that these costs would in reality be substantially smaller than in theory. They imagine that the market would correct for these flaws by means of implementing strict covenants.[130]

In reality, however, covenants will prove to be impossible to draw up. Not only is there a risk of hidden information for the debt holders, but a corporation's operating results are not a

[122] Bradley and Rosenzweig 1992, p. 1079.
[123] Bradley and Rosenzweig 1992, p. 1082.
[124] Furthermore, they would have to decide whether they would want to keep current management in place.
[125] Bradley and Rosenzweig 1992, p. 1083-1084.
[126] Bradley and Rosenzweig 1992, p. 1084.
[127] Adler 1994B, p. 816.
[128] Richard V. Butler and Scott M. Gilpatric, *A re-examination of the purposes and goals of bankruptcy,* 2 Am. Bankr. Inst. L. Rev. 269, 276 (1994).
[129] Rasmussen 1994, p. 1197.
[130] Bradley and Rosenzweig 1992, p. 1087.

reliable measuring stick for optimal investment behavior.[131] An approval clause for future investment will also not work, for this would give a debt holder an incentive to refrain from approving a certain project if the debt holder foresees that a default would be more beneficial than a debt repayment.[132]

Bradley and Rosenzweig explicitly state that they expect no common pool problem to arise in case of a Contingent Equity corporation.[133] Therefore they do not propose to eliminate the possibility of individual debt collection. They state that they expect creditors to draw up contracts that contain the precise conditions under which default-contingent provisions can be enforced and the rule that cancels the interests of the residual claimants upon default. Thus, creditors have precisely defined relative rights and priorities and nothing to gain from the equity class.[134]

Adler argues that it is correct that in a Contingent Equity corporation the common pool problem for creditors in relation to shareholders would be prevented, but that a common pool problem would still exist because creditors would still have a lot to win from beating other creditors in their race to the courthouse. Which is precisely the kind of competition that would threaten the going-concern surplus of a corporation.[135]

2.4 The costs of automatic restructuring

The impossibility to seek individual recourse under the Chameleon Equity proposal and the possibility to do so in the Contingent Equity proposal, is the one major difference between these proposals. The similarities between the proposals are much greater than the differences. Both proposals are contractual structures implemented ex ante and both introduce automatic restructuring upon default. This means that both proposals face the same problems. Two of those problems loom quite large in particular: non-consensual claimants and transaction costs. Other relevant obstacles for replacing bankruptcy law with ex ante capital structures are behavior by management and monitoring costs.

Non-consensual claimants

Non-consensual claimants have not contracted with a debtor. Therefore a non-consensual claimants could not lose his right to individually collect from a debtor.[136] This – at least in the Chameleon Equity proposal - creates the possibility for non-consensual claimants to compete for the assets of the debtor, while the Chameleon Equity creditors could only stand by and watch.[137]

Adler purports to solve this problem by not only eliminating individual debt collection for consensual claimants, but also for non-consensual claimants.[138] In return, non-consensual

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[131] Rasmussen 1994, p. 1172. Bad operating results are not always a result of bad management. There can also be exogenous factors that cause lower operating results.
[132] Robert K. Rasmussen, *The ex ante effects of bankruptcy reform on investment incentives,* 72 Wash. U. L.Q. 1159, 1197 (1994).
[133] Bradley and Rosenzweig 1992, p. 1085, fn 98. As a consequence of their proposal there would no longer be a need for the automatic stay of 11 USC § 362.
[134] Bradley and Rosenzweig 1992, p. 1085, fn 98
[135] Adler 1993A, p. 333.
[136] Butler and Gilpatric 1994, p. 275; Samuel L. Bufford, *What is right about bankruptcy law and wrong about its critics,* 72 Wash. U. L.Q. 829, 840 (1994) and Tabb 2004, p. 269 Adler admits as much. See: Adler 1993A, p. 339.
[137] Adler 1993A, p. 340.
[138] Adler 1993A, p. 340. This would of course form a breach on the freedom of contract so fervently supported by Adler. See: Tabb 2004, p. 270.

claimants would become the highest priority claimants of the debtor.[139] However, Adler fails to recognize that claimants are not always neatly divided between consensual and non-consensual claimants.[140] Some claimants think they deal consensually with the debtor, but in hindsight their decisions turn out to be based on fraud or misinformation. For others it is simply unclear whether their claim follows from a consensual or non-consensual dealing with a creditor.

In the Contingent Equity proposal of Bradley and Rosenzweig every creditor still has the possibility of individual debt collection until the debtor defaults. In practicality, however, this would not permit them to enforce their rights.[141] The group of non-consensual claimants with regard to a debtor can consist of thousands of claimants scattered over the entire globe, unaware of each others existence. How would these claimants - lowest ranking after equity - be supposed to remedy a default under an Contingent Equity regime? As Warren vividly illustrates:

"Consider the plight of claimants against Dalkon Shields manufacturer A.H. Robbins, in a hypothetical situation in which Robins had defaulted on a senior debt obligation of $ 100 million. Would the thousands of women who were injured by the Dalkon Shield receive telephone calls requiring them to come up with a $ 100 million debt payment by sundown or face loss of their claims?"[142]

Therefore, even if the Chameleon Equity and Contingent Equity structure would work in theory, it is hard to imagine that these proposals could adequately deal with non-consensual claimants in reality. In other words: there is a collective action problem.

Imperfect markets and transaction costs

Another and perhaps even bigger problem is the assumption of perfect markets inherent in both Adler's proposal and that of Bradley and Rosenzweig. In reality, however, markets are not perfect and substantial transaction costs will be incurred.[143]

A problem that illustrates this point is that Adler seems to assume that illiquidity of assets does not exist. In real life, however, selling an asset for its true value can take time, money and effort.[144] Furthermore, in order for automatic restructuring to work there always has to be an active market on which equity can be traded. While this may be the case for publicly held corporations, it is highly doubtful that this is true for privately held corporations.[145] The problem with illiquidity is that the residual equity class is extinguished too soon.[146] Adler argues that this problem can be solved easily by means of implementing a certain waiting period after a default and before transformation of a class can take place. This way the residual equity class would have the time to demonstrate that the corporation is merely illiquid and not insolvent.[147] This, however, does not take into account that corporations

[139] Adler 1993A, p. 340.
[140] Tabb 2004, p. 270.
[141] ElizabethWarren, *The untenable case for the repeal of Chapter 11,* 102 Yale L.J. 437, 472 (1992).
[142] Warren 1992, p. 472.
[143] Butler and Gilpatric 1994, p. 274.
[144] This criticism is also valid for the Contingent Equity proposal of Bradley and Rosenzweig. See: Tabb 2004, p. 269.
[145] It is also questionable whether investors would want to buy equity in a closely held corporation. Especially if it is a minor interest. See: Skeel 1993, p. 484.
[146] Lynn M. LoPucki, *Strange visions in a strange world: a reply to professors Bradley and Rosenzweig,* 91 Mich. L. Rev. 79, 100 (1992); Korobkin 1993, p. 716-719 and Skeel 1993, p. 483-484.
[147] Adler 1994B, p. 822-823.

sometimes may be able to sell the equity within the specified period of time, but only under high pressure. This time pressure will reduce the price of the equity being sold.[148] Furthermore, the significant costs of placing equity on the market should also be taken into account for a fair review of the contractualist proposals.[149]

Related to the point of illiquidity is the fact that a single default would trigger the automatic cancellation of the equity class, thus exposing nearly all corporations that carry debt to the risk of bankruptcy.[150] Even corporations that are highly solvent will be threatened with automatic cancellation due to the mere fact that their accountant forgets to pay a small bill.[151]

Moreover, there will be an enormous amount of administration and coordination costs involved in the introduction of an automatic restructuring regime.[152] These costs are firstly caused by the fact that the debtor has to coordinate the contracts with each individual debtor to ensure that the automatic cancellation regime is in place.[153] There will be costs involved in this effort. These costs have to be borne by all corporations, in contrast to the bankruptcy regime where coordination costs are only borne by the corporations involved.[154] Adler argues that these costs would be made primarily by some early pioneers of the structure and that these costs would be trivial in the long run.[155] Thus, while the costs of enforcing a contract – including the costs of reorganizing - would be severely diminished, the ex ante costs of this contract would rise only slightly. Whether these costs really would be trivial remains to be seen. The implementation of special provisions, like a grace period for the equity class, would require specifically tailored contracts. Which would result in complex and costly contracts.[156]

A second source of costs caused by introducing an automated restructuring regime are the costs of extensive litigation. This litigation will mainly be about the question whether a default really occurred. Adler states that these costs are also made under bankruptcy law.[157] This point of view, however, fails to take into account that because of the severe consequences of a default, litigation would probably be more extensive and thus costlier. The class next to the equity class, for example, would have every incentive to declare default, even for the nuisance value of their claim.[158]

And even in the absence of transaction costs it remains questionable whether creditors would choose to write a contract like the one proposed by Adler or Bradley and Rosenzweig. The reason being that a debtor's contracts are not concluded all at the same time, but in a sequential nature.[159] Because of this sequential nature a creditor (B) that comes after another creditor (A) will have an incentive to refuse to give up on his right of individual debt

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[148] Skeel 1993, p. 483.
[149] Skeel 1993, p. 483 and Lubben 2001, p. 286.
[150] Korobkin 1993, p. 718-719.
[151] LoPucki 1992, p. 104.
[152] LoPucki 1992, p. 101-103 and Korobkin 1993, p. 720-721.
[153] Korobkin 1993, p. 720; Butler and Gilpatric 1994, p. 277; Rasmussen 1994, p. 1197; Robert K. Rasmussen and David A. Skeel, *The economic analysis of corporate bankruptcy law,* 3 Am. Bankr. Inst. L. Rev. 85, 108 (1995).
[154] Susan Block-Lieb, *The logic and limits of contract bankruptcy,* 2001 U. Ill. L. Rev. 503, 550.
[155] Adler 1993, p. 324; Adler 1994B, p. 817 and Adler 1994A, p. 1135.
[156] Block-Lieb 2001, p. 550.
[157] Adler 1994B, p. 817 and Adler 1994A, p. 1118.
[158] Korobkin 1993, p. 720.
[159] Stanley D. Longhofer and Stephen R. Peters, *Protection for whom? Creditor conflict and bankruptcy,* 6 Am. L. & Econ. Rev. 249, 253 (2004).

collection, because in such event creditor B can offer a lower interest rate.[160] This method will only work if the contract of creditor A is already fixed. Since creditor A knows he can be exploited if he is the only creditor that gives up on his right of individual debt collection, creditor A will also refuse to give up on his right of individual debt collection.[161]

Strategic behavior

Adler as well as Bradley and Rosenzweig argue that a major source of inefficiency of Chapter 11 are the perverse incentives for management, because they keep control over the corporation and the reorganization process during bankruptcy of a corporation.[162] To eliminate these incentives they propose to introduce the Chameleon Equity corporation and the Contingent Equity corporation, respectively. Both procedures would make it possible for management to be ousted immediately upon default.[163] Although neither proposal is really explicit on what should happen after a default that would improve management.[164]

Adler suggest that after an equity cancellation the new equity class would hold a vote on management.[165] This, however, would result in substantial costs, which consist of both the costs of holding an election and the costs of foregone investment opportunities.[166] This could lead to the ordinary creditors striking a deal with management not to make extraordinary efforts to forestall default. In exchange, management would retain their position after default.[167] Not only would this save the ordinary creditors the costs of a change of management, it could even provide them with a net benefit. This is true when the value of a corporation is higher than the outstanding debt to the secured and unsecured creditors.[168] When this is the case unsecured creditors have a strong incentive to get a corporation to default on technical grounds, because they will become entitled to the surplus of value that exceeds the amount of debt owed to the secured creditors.

Furthermore, it is questionable whether cancellation of shareholders' claims upon default would result in managers seeking optimal operating strategies. It could well be that management would abandon those strategies well before actual payment is due. [169] The reason being that management would rather play it safe than seeking optimal investments with a greater risk of job loss.[170]

The argument that management of a healthy corporation would not adopt suboptimal strategies, because they would have no reason to fear default is inadequate. Even healthy corporations may default. Whether it be by mistake or by temporary cash flow problems.[171] Good management would guard against these risks. This can lead to suboptimal behavior. For

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[160] Longhofer and Peters, p. 263.
[161] Longhofer and Peters 2004, p. 264.
[162] Adler 1993A, p. 315; Bradley and Rosenzweig 1992, p. 1045-1047.
[163] Adler 1993A, p. 324; Bradley and Rosenzweig 1992, p. 1079.
[164] See: Aghion, Hart and Moore 1994, p. 865.
[165] Adler 1993A, p. 325.
[166] Skeel 1993, p. 486 and Rasmussen 1992, p. 99.
[167] Skeel 1993, p. 486.
[168] Skeel 1993, p. 485.
[169] Bradley and Rosenzweig themselves raise this objection. See: Bradley and Rosenzweig 1992, p. 1086-1087.
[170] Rasmussen 1994, p. 1200 and Korobkin 1993, p. 721. This is especially true for bad management. They would want to avoid default at any cost.
[171] Korobkin 1993, p. 722. Temporary cash flow problems can arise, for example, because of a temporary spike in interest rates or a major customer failing to pay. They can also arise because the debtors of the debtor default on obligations and the debtor receives equity instead of cash, which it is unable to sell within a sufficiently short period of time.

example, if management does not invest in projects with net present value, but holds available funds as a buffer to prevent default. Creditors would have no incentive to change this behavior, because this behavior would minimize the risk of default on the obligations of the corporation against these creditors. Management would have no incentive to change their strategies, because this leads to an increased risk of them losing their jobs. In this respect an agency problem exists.

It is important to note that this kind of suboptimal behavior would always occur. For this reason covenants that 'debt obligations are only payable from certain sources, and drastic changes in the corporation's operating strategies would require creditor approval' would not work.[172]

Monitoring

Because of the severe consequences of default it is to be expected that a debtor will try and narrow the scope of default terms.[173] These narrower covenants would result in increased costs. Of course there are the increased costs of drafting the covenants. Under current law little costs are incurred with regard to having broad covenants. These costs would increase because of the consequences of default under a Chameleon Equity or Contingent Equity regime. This, in turn, increases the need for precisely drafted and tailored covenants, which are costly to draw up.[174] A cost that neither Adler nor Bradley and Rosenzweig seem to take into account completely.

Another consequence of narrower covenants is that the need for monitoring increases. Under current law covenants can function as tripwire, signaling the need for increased monitoring.[175] Because breach of a covenant under an automatic restructuring regime means default, this tripwire function would be lost and creditors would need to monitor their debtor more closely.[176]

Rasmussen has argued that the implementation of Chameleon Equity would cause a cost by means of removal of the incentive for the secured creditor to monitor specific assets. This monitoring of certain assets is seen as the explanation of secured credit.[177] Since the highest priority claim holders have entire-corporation priority rather than asset specific priority they would have no benefit of monitoring specific assets.[178] Adler, however, sees an easy solution for this cost. A Chameleon Equity corporation could limit a claimant's priority to the value of collateral, place secured claimants in a low priority class and give the claimant the right to demand an auction for their collateral in case of a default on his claim.[179]

2.5 Bankruptcy as a default rule: a choice by menu

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[172] Bradley and Rosenzweig 1992, p. 1087. This covenant is proposed by Bradley and Rosenzweig to prevent management from taking unduly risk in an ultimate effort to pay outstanding debt obligations. This is a different situation than described here. The covenant described would also be strongly opposed by the equity class, because it would lead to an increased risk of default and, thus, to an increased risk of automatic cancellation. Korobkin 1993, p. 726.
[173] Skeel 1993, p. 490.
[174] Rasmussen 1994, p. 1198.
[175] Rasmussen 1994, p. 1199.
[176] Skeel 1993, p. 490.
[177] Adler 1994B, p. 819.
[178] Rasmussen 1992, p. 99
[179] Adler 1994B, p. 821.

Another proposal involving an ex ante capital structure as a replacement for bankruptcy law has been advanced by Rasmussen. He has argued that bankruptcy should be seen as a term of contract between the investors of a corporation.[180] For this reason he proposes to introduce a menu of choices for a corporation to choose from. This choice would decide what kind of procedure would be followed in case of financial distress so as to reach an efficient outcome.[181]

2.5.1 Bankruptcy as a term of contract

Rasmussen starts by arguing that bankruptcy is a foreseeable event for the parties involved at the moment a creditor decides to extend credit to a debtor.[182] This fact is therefore reflected in the lending decision. A lender will compare the return it can expect from the borrowing corporation with the best available alternative, thus setting a minimum price. The maximum price is set by the available alternative sources of financing for the borrower.[183] However, when calculating the price the lender will not only take the probability of default, but also existing bankruptcy law into account. The reason for this is that default does not mean that a lender will not be repaid at all. Thus, bankruptcy should be seen as a term of the contract between the corporation and a creditor that shows what a lender will receive once the borrower enters bankruptcy.[184] It is not, according to Rasmussen, the term of contract between the creditors themselves to maximize their respected returns.[185]

Once it is accepted that bankruptcy is a term of contract, the fact that bankruptcy law is mandatory can be questioned.[186] Rasmussen argues that those advocating the mandatory nature of bankruptcy law have to provide for a justification of this statement.[187] In light of this he discusses two possible justifications for mandatory bankruptcy law: the common pool problem and the standardization argument.

Rasmussen contends that the common pool problem is not a satisfactory justification for the mandatory nature of bankruptcy law.[188] The reason being that lenders price their loans with bankruptcy law in mind. Costs associated with common pools are therefore already taken into account in calculating an interest rate as to even out the risk that lenders will not be able to get their loan repaid in full. Because the shareholders are the residual claimants of a corporation they will bear the costs of suboptimal action. The equity class is therefore in the best position to ensure the largest return to the corporation.[189] For this reason they should select the applicable rules in bankruptcy.

The standardization argument is, according to Rasmussen, also not a satisfactory justification for the mandatory nature of bankruptcy law.[190] The standardization argument can be broken up into two separate arguments: the transaction cost argument and the strategic behavior argument. The transaction argument holds that if each corporation had to design its own bankruptcy rules the cost of this effort would exceed the efficiency gains. The strategic

[180] Rasmussen 1992, p. 53.
[181] Rasmussen 1992, p. 53.
[182] Rasmussen 1992, p. 56.
[183] Rasmussen 1992, p. 56. The price of the loan is the interest that is being charged.
[184] Rasmussen 1992, p. 57.
[185] Rasmussen 1992, p. 59. With reference to the creditors' bargain theory of Baird and Jackson.
[186] See for the mandatory nature of American bankruptcy law: United States v. Royal Business Funds Corp., 724 F.2d 12, 15 (2d. Cir. 1983).]
[187] Rasmussen 1992, p. 63.
[188] Rasmussen 1992, p. 64-65.
[189] For they have the most to lose.
[190] Rasmussen 1992, p. 65-67.

behavior argument holds that fear that different creditors may be subject to different bankruptcy regimes may lead a creditor to try and maximize his return under the assumption that the other creditors would try and minimize his return. This fear would be justified if a debtor cannot credibly offer only one bankruptcy regime.

Rasmussen, however, thinks the standardization argument unconvincing. He argues that the introduction of a menu approach solves both the transaction cost argument as well as the strategic behavior argument.[191] The menu approach would minimize transaction costs, because the options are known in advance. Creditors would therefore choose between several standard procedures.[192] If the possibility to change a selection were limited after a corporation has taken out credit, the strategic behavior problem would be eliminated.[193]

Rasmussen makes one exception to the proposition that the investors should be able to choose the applicable provisions in bankruptcy.[194] This is when non-consensual claimants are involved. Because they have not contracted with the corporation, they have not been able to bargain over the terms over the contract. Which makes it likely that the corporation will try and externalize the costs of bankruptcy on these claimants. The solution for this problem, according to Rasmussen, is to have a mandatory bankruptcy regime for this specific class of claimants.[195]

But, if parties could choose, then why would they not just choose Chapter 11? Rasmussen argues that the reason for this is that the costs of Chapter 11 are quite high.[196] These costs are related to the fact that American bankruptcy law gives shareholders certain procedural protections. An example of such a protection is the exclusivity period.[197] Another example is the fact that the bankruptcy court may hold a valuation hearing. And that valuation is a hypothetical value of the corporation and not an objective figure.

2.5.2. The bankruptcy menu

The proposed bankruptcy menu would have five options available for the investors to choose from: i) no-bankruptcy (including a possibility for a contingent equity structure), ii) liquidation only (auction-regime), iii) an administrative reorganization procedure, iv) a selective automatic stay (excluding the financing debtor) and v) a custom-designed bankruptcy system.

The first option involves that the corporation would commit to never filing for bankruptcy, but would rely on only individual debtor collection or become a contingent equity corporation upon default.[198] This bankruptcy would be most suited for corporations consisting of a single asset, no corporation-specific value contribution by the shareholders and a secured creditor whose claim exceeds the value of the asset. In this scenario creditors

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[191] Rasmussen 1992, p. 66.
[192] Rasmussen 1992, p. 66. One of the options on the menu would still be to create a whole new bankruptcy procedure. See below. A benefit of the menu approach would be that lenders would be able to anticipate on the different bankruptcy regimes and would be able to show the different interest rates they charge, thus showing the costs of bankruptcy to a debtor.
[193] Rasmussen 1992, p. 66.
[194] Rasmussen 1992, p. 67.
[195] Rasmussen 1992, p. 67.
[196] Rasmussen 1992, p. 80.
[197] 11 USC §1121 gives the debtor the exclusive right to file a reorganization plan for 120 days after the order for relief.
[198] Rasmussen 1992, p. 100-102. Rasmussen uses the name 'contingent equity', but seems to refer to the Chameleon Equity proposal of Adler. See: Rasmussen 1992, p. 102, fn 217.

would have nothing to gain from a bankruptcy procedure, because it is clear that the secured creditor should sell the asset and receive all the proceeds.[199]

The second option is that a corporation can only file for liquidation by means of an auction.[200] Rasmussen argues that this option would be preferred by shareholders in a public corporation. Because the corporation is auctioned bankruptcy would take a relatively short time, thus reducing the direct costs that would be made in a reorganization process and providing for a relatively quick pay-out. At the same time, Rasmussen argues, the corporation will be kept intact if that provides for value maximization. A possible benefit of 'reorganizing' a corporation by means of an auction is that the pro rata sharing rule applies. General creditors may benefit from this rule, thus prompting lower interest rates for the debtor.[201] This would eventually be to the benefit of the shareholders. Shareholders can diversify the risk of the corporation's bankruptcy by buying shares in different companies.[202]

An administrative reorganization procedure would - as the third choice - also be available under the menu approach.[203] This procedure would be preferred by shareholders who cannot diversify risk or who have non-pecuniary investments in the corporation. Furthermore, a hypothetical sale may - in the end - have lower costs than an actual sale and thus an administrative reorganization procedure as a choice is justifiable.[204]

As a fourth option Rasmussen advances the option to choose for a selective automatic stay.[205] All creditors would be stayed upon filing - and be unable to exercise their collection rights - except for the financing creditor. The reason for the exemption of the automatic stay for the financing creditor is that this will give management an incentive not to shirk. For the financing creditor - so Rasmussen assumes - can detect whether the corporation fails because of endogenous or exogenous events.[206] In the first instance management has shirked and the financing creditor should be able to call the loan. In the second instance the financing creditor will renegotiate the loan. For this renegotiation to be able to succeed the financing creditor and the debtor need time, thus the other creditors should be barred from exercising their rights.[207]

The fifth and final option is to let corporations create their own bankruptcy regime. Rasmussen sees no objection to let corporations create their own regime if the gains exceed the cost of such an effort.[208] The only condition is that non-consensual creditors should be subject to a mandatory rule.

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199 Rasmussen argues that the ability to file for bankruptcy and the consequential automatic stay of 11 USC §362 would provide shareholders with the opportunity to stall debt collection in the hope the corporation will turn solvent again. The costs of this delay would be reflected in the higher cost of credit. See: Rasmussen 1992, p. 101.
200 Rasmussen 1992, p. 102-105.
201 Rasmussen 1992, p. 104.
202 Rasmussen 1992, p. 104. Since managers cannot diversify their risk their incentive to engage in risky adventures is reduced. For if a corporation went bankrupt under the auction-option, management would be ousted.
203 Rasmussen 1992, p. 105-106.
204 Rasmussen 1992, p. 105. With reference to Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. Fin. Econ. 411, 416-417 (1990).
205 Rasmussen 1992, p. 106.
206 Rasmussen does not discuss the situation that both endogenous and exogenous circumstances lead to the bankruptcy of a corporation.
207 Rasmussen 1992, p. 106.
208 Rasmussen 1992, p. 106-107.

2.5.3 Selecting and changing options

In the proposal of Rasmussen a corporation will choose an option from the menu at the time of its incorporation. Furthermore, it is conceivable that a corporation would wish to change its choice over time as the corporation evolves.[209]

With regard to choosing an option at the inception of a corporation a moral hazard problem exists.[210] Especially with regard to the options on the menu that present some form of insurance for the shareholders. Shareholders in a corporation that have chosen an option which leaves them with an interest after the reorganization know that they will not bear the full costs of failure. They would, presumably, have a taste for riskier investments as these options presents them with a certain kind of 'insurance'.

Rasmussen, however, argues that the moral hazard problem is at most equal to mandatory bankruptcy law.[211] First, Rasmussen argues, there is always a moral hazard problem. Even in a solvent corporation the shareholders do not bear the full risk of failure.[212] Second, the insurance payoff given under the relevant options is not a set amount, but rather a percentage of the reorganized corporation. This means that shareholders have an incentive to avoid projects that are too risky. As a result, although they will not bear the full consequences of failure, they will certainly feel some consequences.

Another problem is that corporations change. They evolve over time. This means that most corporations probably like to change their choice for a bankruptcy regime over time.[213] However, simply allowing corporations to randomly change their choice would take away many of the contended benefits of the menu approach, because a corporation could not make a credible commitment to its creditors. This is especially true if a corporation could switch from an option that deprives shareholders of a pay-out in case of bankruptcy to an option that does give shareholders a pay-out. If this were possible a lender would anticipate this behavior and charge a higher interest rate.[214]

In light of the above Rasmussen argues that no objections exist for corporations that wish to change from the administrative reorganization procedure option to the auction option.[215] If corporations wish to change the other way around Rasmussen argues that this should only be possible with the consent of all the creditors.[216]

Moreover, corporations will sometimes probably wish to change to or from the no-bankruptcy option.[217] With regard to a change to the no-bankruptcy option Rasmussen sees a risk of preferential payment. Where other options include a pro rata payment for general creditors, the no-bankruptcy option provides for the possibility of preferential treatment of a

[209] Rasmussen 1992, p. 111-112.
[210] Rasmussen 1992, p. 112. A moral hazard problem occurs when someone does not bear the full consequences of their action.
[211] Rasmussen 1992, p. 113-114.
[212] For a certain amount of risk is borne by the debt holders. At the same time the shareholders receive the entire surplus of the corporation after the debt holders have been satisfied.
[213] Rasmussen 1992, p. 116-117.
[214] Rasmussen 1992, p. 117.
[215] Rasmussen 1992, p. 117.
[216] Rasmussen 1992, p. 118. For example, a corporation would probably wish to make this kind of change if it went from a public corporation to a private corporation by means of a leveraged buyout.
[217] Rasmussen 1992, p. 188.

certain creditor.[218] Rasmussen suggests solving this problem by either demanding unanimous creditor consent or by setting a certain waiting period before the corporation could change.[219]

A switch away from the no-bankruptcy option could induce shareholders to seek an option that includes an automatic stay to protect their interests, thus preventing collection efforts of a creditor that would be available under the no-bankruptcy option. Rasmussen argues that unanimous creditor consent is the best available way to prevent such behavior.[220]

Finally, Rasmussen argues that changing to or from the selective stay option should also be regulated.[221] Moving away from the selective stay option would need the approval of the financing lender. Moving to the selective stay-option would need unanimous creditor consent. Otherwise there would be a risk of preferential treatment of the financing creditor.[222]

2.6 Costs of the menu approach

Some of the flaws inherent in the proposals for automatic restructuring are also inherent in the menu approach. For example, the problem of dividing non-consensual and consensual claimants also exists under the menu approach.[223] Furthermore, the problem of transaction costs also exists under the menu approach, because a contract would have to be closed between the debtor and all of his creditors.

With regard to the problem of transaction costs Rasmussen tries to provide a solution by advancing that the debtor includes his choice for a bankruptcy regime in his articles of association.[224] This, of course, can hardly be qualified as a choice made by the creditors of the corporation.[225] Furthermore, it is unlikely that a debtor has sufficient information at the time of his incorporation to make an efficient choice.[226] This problem may be solved by the ability to change regimes. However, the fact that Rasmussen requires consent by all creditors to make certain changes makes his proposal highly impractical.

Furthermore, how would the creditors receive notice of a change of choice? Sending every creditor notice to invite them to consent with a change of choice bears a certain amount of costs.[227] If not for the costs of sending the notice then for the effort it takes to determine who is eligible to consent. If the choice can be made by simply changing the charter of a business and leaving it that way for a certain period of time, creditors would still need to know under what bankruptcy regime a business functions so they can adjust their prices accordingly.[228] Rasmussen sees a solution for this problem in the possibility for a creditor to search corporate records.[229] These searches, however, would have to be performed regularly and at certain

[218] Since bankruptcy law is not applicable under the no-bankruptcy option preference law would also not be applicable.
[219] Rasmussen 1992, 119.
[220] Rasmussen 1992, p. 119-120.
[221] Rasmussen 1992, p. 120.
[222] Rasmussen 1992, p. 120.
[223] Tabb 2004, p. 270 for a description of this problem.
[224] Robert K. Rasmussen, *Resolving transnational insolvencies through private ordering*, 98 Mich. L. Rev. 2252, 2254 (2000).
[225] Tabb 2004, p. 268.
[226] Tabb 2004, p. 269 and Skeel 1993, p. 482.
[227] LoPucki 2000, p. 2244.
[228] This, of course, would reintroduce a moral hazard for the class of shareholders, who could simply change the charter as to chose the option that is most convenient for them at any given time.
[229] Rasmussen 2000, p. 2266.

costs. Furthermore, each search would have to be analyzed and verified on correctness, which brings along further costs.

Many small creditors will not undertake such efforts and simply extend credit. They will therefore not monitor the debtor, but take as a starting point that the debtor has chosen the bankruptcy regime that is most disadvantageous to the creditor and price their credit on the basis of this assumption.[230] This may provide for inefficiencies. It may also be that there are maladjusting creditors present in the pool of creditors. Maladjusting creditors are creditors who are unable to adjust their prices to the amount of risk forced upon them, because they do not have sufficient bargaining power to avoid bearing those risks.[231] These creditors are not merely tort victims, but also employees, taxing authorities and trade creditors.[232] As Rasmussen admits, maladjusting creditors cannot price their credit to the amount of risk and the debtor will have an incentive to chose a bankruptcy option that exploits this.[233] It is true that the costs involved are caused by the maladjustment of certain creditors, but the point is that the menu approach promotes this kind of behavior.[234]

2.7 The costs of contractualism

As described in the preceding section the menu approach has a problem with giving proper notice to its creditors and the markets of which option is presently applicable to a corporation. This problem of notice, however, also plays a role in the other proposals discussed in this Article that are based on contractualism.[235] Furthermore, contractualism does not provide for proper control over the assets of a corporation. Without asset constraint the debtor has a broad opportunity to transfer, both in good faith and in bad faith, assets prior to default. This can leave the creditors with few assets to seek recourse on.[236] This problem could be solved by contractual covenants, but it is questionable whether these covenants would be effective.[237] Post default the contractualist proposals lack a mechanism for control of the asset, so that rights can be enforced and sales can be effectuated.[238] The different proposals say nothing about who would control the assets of the debtor after a default, who would appoint the controller or what his objective would be.[239]

Westbrook argues that if a contractual solution for financial distress is preferred, only a dominant security interest would provide a workable solution.[240] In this respect he

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[230] Lynn M. LoPucki, *The case for cooperative territoriality in international bankruptcy,* 98 Mich. L. Rev. 2216, 2245 (2000).
[231] Elizabeth Warren and Jay L. Westbrook, *Contracting out of bankruptcy: an empirical intervention,* 118 Harvard L. Rev. 1197, 1214 (2005). Warren and Westbrook have empirically tested that in 79.5% of their researched samples there was at least one maladjusting creditor.
[232] Big creditors with small claims may also be maladjusting, because the size of the claim does not justify the research needed to calculate the risks and price their credit accordingly. However, if one creditor holds many small claim large inefficiencies can arise.
[233] Rasmussen 2000, p. 2266.
[234] LoPucki 2000, p. 2249.
[235] See: Jay L. Westbrook, *Bankruptcy control of the recovery process,* 12 Am. Bankr. Inst. L. Rev. 245, 248 (2004A), where several aspects of the problem of notice are discussed.
[236] Westbrook 2004A, p. 249 and Jay L. Westbrook, *The control of wealth in bankruptcy,* 82 Tex. L. Rev. 795, 833-834 (2004B).
[237] Westbrook 2004A, p. 249. These covenants would not affect the asset transfer itself, but only give a creditor a contractual obligation.
[238] Westbrook 2004A, p. 249.
[239] Westbrook 2004B, p. 835.
[240] Westbrook 2004A, p. 247. Westbrook, however, thinks the widespread use of a dominant security interest is both unfeasible and undesirable.

specifically refers to article 9 of the U.S. Uniform Commercial Code.[241] This article provides for a method of both notice and asset control. Westbrook argues that the holder of the security interest would have to be dominant. This would prevent the arising of a competition for which bankruptcy regime is applicable and provides for complete control over the debtor and its assets.[242]

Related to Westbrook's assessment are the assertions made by Picker. According to Picker a common pool problem can arise with regard to a debtor. He argues, that security rights can severely minimize this.[243] Thus suggesting that bankruptcy law has a very limited function at most.

According to Picker parties involved in extending credit can minimize the common pool problem by structuring their relationships.[244] Picker gives the example of a secured creditor that is owed more than the assets would be worth if a corporation failed.[245]

Furthermore, if the parties anticipate a common pool problem, they will also try to minimize the harms of the common pool. Therefore they will charge interest rates that compensate the losses that are to be expected.[246] These losses are a consequence of the fact that a debtor will pursue a riskier investment strategy if creditors are involved. The reason being that it is not the debtor's money that will be lost if he fails. To prevent this 'debtor misbehavior' a creditor can, according to Picker, monitor or he can acquire ex ante rights by contract.[247] Picker contends, however, that contractual solutions do not suffice to prevent debtor misbehavior. Not only will the debtor still be able to take increased risks, it will also be very difficult, if not impossible, to draft a contract that ensures that a debtor will choose the strategy that is most beneficial for the creditor.[248] And, furthermore, if a contract can be drafted and that contract is breached, the creditor still has to convince a judge of this fact.[249] Thus, Picker asserts, creditors will generally monitor their debtor.

However, monitoring produces additional problems for creditors. When multiple creditors are involved there is the risk that creditors will duplicate each other's monitoring.[250] Furthermore, if a creditor monitors he has information that he can use to his advantage. Which means that he can, if he deems it necessary, try to seek full payment from a debtor, thus trying to avoid the pro rata regime that is used in bankruptcy.[251] In other words, there is a risk of creditor misbehavior.

3. The auction-alternative

There have also been non-contractualist proposals that are intended as an improvement in efficiency with regard to bankruptcy. Two prominent examples of such proposals are the mandatory auction regime and options-theory. These proposals will be discussed in the following sections.

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[241] Another example is the figure of the floating charge, which is found in Great Britain.
[242] Westbrook 2004A, p. 249-250.
[243] Randal C. Picker, *Security interests, misbehavior, and common pools,* 59 U. Chi. L. Rev. 645 (1992).
[244] Picker 1992, p. 647-648.
[245] Picker 1992, p. 648.
[246] Picker 1992, p. 647-648.
[247] Picker 1992, p. 653.
[248] Picker 1992, p. 656-657. An example of increased risk taking is asset substitution. This means that a debtor will substitute low-risk assets for high-risk investments.
[249] Picker 1992, p. 657.
[250] Picker 1992, p. 657.
[251] Picker 1992, p. 657 and p. 671.

3.1. A mandatory auction regime

Baird, in a series of articles, has shown to be critical of the justification for the existence of an administrative reorganization procedure.[252] He argues that it may well be that a bankruptcy regime that would provide for a mandatory auction of a corporation on the open market shortly after it has filed for bankruptcy is more efficient than a reorganization procedure. Baird contends that there are three reasons why an auction is more efficient: i) the elimination of the valuation problem, ii) lower costs and iii) the lack of going-concern surplus in corporations.

As discussed above in § 1 of this Part an administrative reorganization procedure involves a hypothetical sale. Baird argues that this valuation is 'tricky' and that there is no reason to assume that the shareholders or the judge will value a corporation more correctly than outsiders.[253] Shareholders have an incentive to overvalue the corporation, because the higher the valuation the more they will receive. And, because a judge receives no benefits and suffers no costs, he has no incentive to value a corporation correctly.[254] So, while it may be that outsiders may not value a corporation correctly, it is not said that they are less capable of valuing a corporation.[255]

Furthermore, by eliminating the hypothetical valuation and providing for an actual one the deployment and the distribution question are separated.[256] This prevents the inefficient use of assets, because parties are fighting over who gets what. After the sale the assets will be owned by someone who has an incentive to put the assets to its best use, because he will incur both the costs and the benefits. The claimants in the bankruptcy can then argue about their relative entitlements.[257]

With regard to costs Baird notes that it is not so much the direct costs with regard to administrative reorganization procedures that cause inefficiencies, but rather the indirect costs.[258] Management – as an agent of equity – has an incentive to delay a reorganization procedure as long as possible, hoping that the corporation's fortunes may change for the better and they receive a bigger part of the pie.[259] So, it could be that the corporation's operations are continued long after it should have been liquidated or that the corporation does not take the necessary steps to remain competitive. These costs may be eliminated under a mandatory auction regime, but a mandatory liquidation would give management an incentive

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[252] Baird 1986, Douglas G. Baird, *A world without bankruptcy,* 50-SPG Law & Contemp. Probs. 173 (1987), Baird 1993, Douglas G. Baird and Robert K. Rasmussen, *The end of bankruptcy,* 55 Stan. L. Rev. 751 (2002), Douglas G. Baird and Robert K. Rasmussen, *Chapter 11 at twilight,* 56 Stan. L. Rev. 673 (2003), Douglas G. Baird, *The new face of Chapter 11,* 12 Am. Bankr. Inst. L. Rev. 69 (2004). Baird takes the Chapters 7 and 11 of the U.S. Bankruptcy Code as a reference. Whether his arguments are also valid under Dutch law is discussed below in Part D. Other proponents of mandatory auctions are Jackson and Jensen. See: Thomas H. Jackson, The logic and limits of bankruptcy law 218-224 (reprint 2001) and Michael C. Jensen, *Corporate control and the politics of finance,* 4 J. Applied Corp. Fin, 13, 31-32 (1991).
[253] Baird 1986, p. 136-137.
[254] Baird 1986, p. 137. See also: Rasmussen and Skeel 1995, p. 93.
[255] Shareholders could, of course, still remain in control of the corporation after the auction, but they would need to make the highest bid.
[256] Baird 1993, p. 634.
[257] Baird 1993, p. 634. Baird does note the possibility of prepackaged reorganization plans that effectively separate the deployment and the distribution question and eliminate arguments over relative entitlements. Baird, however, contends that these cases are 'the exception'. See: Baird 1993, p. 640.
[258] Baird 1993, p. 641-644. Baird assesses that the direct costs of an administrative reorganization procedure are relatively small.
[259] Baird 1993, p. 643-644.

to stall the filing for bankruptcy as long as possible, because bankruptcy would mean that equity would lose its interest in the corporation.

A mandatory auction regime, however, would only be warranted if the costs of an administrative reorganization procedure outweigh those of a public auction. In this respect Baird sees no reason why a corporation should not yield the same amount of money in a speedy auction than in a reorganization procedure.[260] Thus reducing indirect costs, while raising the same amount of money.

Another reason Baird contends that mandatory auctions are justified is that he advances that the traditional justification for having an administrative reorganization procedure - going-concern surplus - does not exist in the large majority of corporations.[261] By discussing major bankruptcies in the United States and nineteenth century cotton mills in Great Britain, Baird argues that modern corporations hardly have any specialized assets dedicated exclusively to them.[262] Thus, assets may work just as well in corporation A as in corporation B and there is no need to retain the specific judicial entity to preserve the value held in certain assets or a configuration of these assets.[263]

3.2 The costs of a mandatory auction regime

Current U.S. bankruptcy law already provides for the opportunity of an auction of a bankrupt corporation if this maximizes value.[264] However, it also provides for the opportunity of reorganizing a corporation by means of Chapter 11. It is this last possibility that supporters of a mandatory auction want to abolish. Throughout the years, however, several drawbacks on mandatory auctions have been advanced in the literature.

Baird contends that the valuation problem that exists in a reorganization procedure is solved by introducing mandatory auctions, because an actual price is paid for the bankrupt corporation. The advantage of this is, according to Baird, that discussions about the valuations over claims can be postponed until it is clear what there is to divide.[265] This, however, does not eliminate the cost of assessing and prioritizing the different claims in a bankruptcy. Costs which can constitute a substantial part of the total costs of a bankruptcy.[266] Furthermore, the need for valuation of assets is not completely eliminated under a mandatory auction regime. This is especially true in case there are secured creditors with claims limited to the value of certain assets of the debtor. In this case a judge would have to decide what the value of those assets – and thus the claim of the creditor – are.[267]

Another reason that the need for valuation would not be completely obviated under a mandatory auction regime is the problem of the residual claimant. Ideally an auction would be conducted by the residual claimants of the debtor, since they have the greatest incentive to attain the highest price for the bankrupt corporation. It is, however, not always clear who the residual claimants of a debtor are. Especially when there are multiple layers of debt. This

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[260] Baird 1993, p. 647.
[261] Baird and Rasmussen 2002, p. 768.
[262] See throughout Baird and Rasmussen 2002; Baird and Rasmussen 2003 and Baird 2004.
[263] Baird and Rasmussen 2002, p. 768. The same goes, according to Baird, for teams of people. Teams may provide for value, but that value is not bound to a particular corporation. See: Baird and Rasmussen 2002, p. 776.
[264] A. Michele Dickerson, *The many face of Chapter 11: a reply to professor Baird,* 12 Am. Bankr. Inst. L. Rev. 109, 114 (2004).
[265] Baird 1993, p. 634.
[266] Easterbrook 1990, p. 416.
[267] Adler 1993A, p. 321.

reintroduces the need for a judge to value a debtor to be able to determine who the residual claimants are.[268]

The problem with a mandatory auction regime is not only limited to vicissitudes over valuation, but also lies in the problem of imperfect markets. The consequence of these imperfect markets is that value maximization of the bankrupt debtor will not always be achieved.

For example, the natural potential buyers of a bankrupt corporation are its competitors. Assuming that the corporation went bankrupt because of exogenous causes it is likely that the competitors face the same depressed market as the bankrupt corporation. It will therefore be hard to raise the capital necessary for buying the bankrupt corporation as a going-concern. Therefore leading to a lack of competition among bidders.[269]

Another reason for lack of competition are the costs involved in preparing a bid. There will be substantial costs involved in preparing a bid. Investment bankers have to be brought on and the corporation will have to be valued in order to be able to make an accurate bid.[270] Furthermore, costs will have to be made to arrange for financing the bid.[271] These costs will only be recouped by the winner of the auction. A potential buyer would therefore need to have a reasonable chance of winning the auction at a price lower than the company's actual value.[272] These costs may well result in bidders not entering the market for the bankrupt corporation, because they consider their chances of winning too low. This results in a lack of competition, which in turn results in lower prices.[273]

Prices will also be lower, because when a bidder wins an auction it not only wins a corporation, but also the substantial risk of a depressed value of the corporation during the time it is in possession of a corporation. For this reason the bidder will only want to buy the corporation at a discount.[274]

Finally, the argument that no going-concern surplus exists in modern businesses can be questioned. It may be that modern businesses do not have many specialized assets, but the going-concern surplus does not only reside in specific assets. It also resides in relationships. Relationships between people, between assets and between assets and people.[275] The going

[268] Easterbrook 1990, p. 415-416. Baird acknowledges this problem. See: Douglas G. Baird, *The hidden virtues of Chapter 11: an overview of the law and economics of financially distressed firms,* Chicago law and economics working paper, 6-7 (1997).
[269] See extensively about this subject: Adrei Shleifer and Robert W. Vishny, *Liquidation values and debt capacity: a market equilibrium approach,* 47 J. of Fin. 1343 (1992). Also see: Aghion, Hart and Moore 1992, p. 528; Rasmussen and Skeel 1995, p. 109 and Dickerson 2004, p. 117. Baird recognizes this problem. See: Baird 1997, p. 6-7.
[270] Adler 1993A, p. 320-321; Skeel 1993, p. 478.
[271] Charles W. Adams, *An economic justification for corporate reorganizations,* 20 Hofstra L. Rev. 117 , 142 (1991).
[272] Lynn M. LoPucki and Joseph W. Doherty, *Bankruptcy fire sales,* 106 Mich. L. Rev. 1, 41 (2007). The lower price is necessary to recoup the costs involved in preparing the bid.
[273] Baird acknowledges that competition among bidders is crucial for this. See: Baird 1993, p. 650. LoPucki and Doherty researched prices of thirty large public bankrupt companies sold between 2000 and 2004 in the United States. They found that companies sold for an average of 35% of book value, but reorganized for an average of 80% of book value. Further, they found the average number of bidders per sale to be 1.6. See: LoPucki and Doherty 2007.
[274] Aghion, Hart and Moore 1992, p. 527.
[275] Lynn M. LoPucki, *The nature of the bankrupt firm: a response to Baird and Rasmussen's the end of bankruptcy,* 56 Stan. L. Rev. 645, 652 (2003). See also: Dickerson 2004, p. 122 with regard to keeping teams together.

concern-surplus flows from the big web of relationships that is formed by a corporation. For example, the relationship between two completely fungible assets can already constitute a going-concern surplus.[276]

The reality of imperfect markets therefore leads us to the conclusion that a regime that would only allow for mandatory auctions would be inefficient. Such a regime would fail to provide for value maximization in every case.

4. (Stock) market based approaches

Besides auctions there have been several proposals to use the market in combination with options in relation to the reorganization of a corporation. The authors of these proposals argue that use of the market will solve the valuation problem inherent in administrative reorganization procedures.

Below two of the proposals advanced in the literature will be discussed. First, the options theory of Lucian Bebchuk will be discussed.[277] His theory is a further development of the slice-of-capital theory advanced by Mark Roe.[278] The voting options theory, as an elaboration on the options-theory as advanced by Bebchuk, will also be discussed.[279]

4.1 Options theory

Bebchuk has advanced a proposal that uses options to provide for a method to divide the value of a reorganized company among its participants.[280] The main aim of the proposal is to improve the existing administrative reorganization procedure.[281] Bebchuk sees at least three inefficiencies in these administrative procedures: i) the valuation problem and resulting strategic behavior, ii) corporations emerging from reorganization with unsound capital structures, iii) the substantial costs involved in the reorganization process.[282]

The valuation problem and the resulting problem of strategic behavior have already been discussed above in § 1 of this Part**.** Because reorganization involves a hypothetical sale the reorganized company has no fixed value, which the participants involved can divide. This leads to strategic behavior. Senior creditors will have an incentive to advance a low valuation, because this leaves them with a bigger part of the reorganized company. Shareholders will advance a high valuation, because this leaves them with an interest in the company.[283] As a result there is a possibility that a dissatisfied party could induce concessions by threatening to withhold its consent to a reorganization plan.[284]

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[276] LoPucki 2003, p. 653. LoPucki gives the example of In re 26 Trumbull Street (77 B.R. 374 Bankr. D. Conn. 1987). The estate consisted of a lease valued at $ 60,000 by the bankruptcy judge and equipment valued at $ 21,500. These two assets were sold together for $ 165,000.
[277] Bebchuk 1988 and Bebchuk 2000.
[278] Mark J. Roe, *Bankruptcy and debt: a new model for corporate reorganization,* 83 Colum. L. Rev. 527 (1983). This theory will be discussed in passing.
[279] Aghion, Hart and Moore 1992; Aghion, Hart and Moore 1994 and Hart, La Porta Drago, Lopez-de Silanes and Moore 1997.
[280] Bebchuk 1988 and Bebchuk 2000. Participants cannot establish how much everyone should get if they do not know how much there is to divide. To this effect Bebchuk also provides for an answer to the valuation problem. Furthermore, Bebchuk takes the size and ranking of claims involved as a given. See: Bebchuk 1988, p. 778.
[281] Bebchuk 1988, p. 776-777. Bebchuk takes the Chapter 11 of the U.S. Bankruptcy Code as a reference. Whether his arguments are also valid under Dutch law is discussed below in Part D.
[282] Bebchuk 1988, p. 780.
[283] Bebchuk 1988, p. 778-779; Bebchuk 2000, p. 831-832.
[284] Roe 1983, p. 540.

With regard to unsound capital structures Bebchuk notes that the capital structure of a corporation should be chosen to maximize the corporation's value, but that in reality there are often strategic factors that play a role in the choice for a capital structure.[285] I will expand upon this point in relation to Roe.

As for the substantial costs Bebchuk points to the direct cost of a reorganization procedure, but also to the loss of value that is possibly involved as a result of lengthy reorganizations and resulting uncertainty.[286]

Roe has also assessed that the inefficiencies that Bebchuk describes exist.[287] With regard to unsound capital structures Roe – like Bebchuk – notes that strategic factors play a role in the determination of the capital structure of the reorganized corporation. Roe gives special attention to the use of debt in a capital structure to obviate the valuation problem.[288] For example, if parties state that a corporation is worth at least € 6 million, but less than € 10 million, debt can overcome the problems that arise because of these different estimates. For parties could agree to a capital structure that consist of - for example - € 5 million due to senior creditors whether the value turns out to be € 6 or 10 million. The other creditors would get the rest, whether that be € 1 or € 5 million. This capital structure would obviate the valuation problem, but there is very good chance that it is not the most efficient one.

Roe contends that the inefficiencies described can be largely solved by requiring courts to confirm only reorganization plans that involve only all-common-stock capital structure. And that the valuation problem of public corporations could be solved by selling a slice – Roe proposes 10% - of common stock in the market and then extrapolate the sale price to find the value of the reorganized corporation.[289]

4.1.1 The options procedure

Bebchuk has stated that he thinks the proposal by Roe is flawed.[290] Roe's method relies heavily on the market for the valuation of a corporation. Bebchuk, however, argues that it is not without question that the market will correctly value a corporation.[291] Furthermore, selling only a slice of the corporation's capital may result in incorrect valuation, because there would be an incentive for some participants to manipulate the market price.[292] Finally, Bebchuk notes that Roe's proposal could only be applied to corporations that trade publicly.[293]

Therefore Bebchuk introduces his own proposal, which does not rely on accurate market pricing, but does make use of the market. Bebchuk takes as a starting point that while the value of the reorganized company – named RC by Bebchuk – is not known, it is known

[285] Bebchuk 1988, p. 780 and Bebchuk 2000, p. 832.
[286] Bebchuk 1988, p. 780 and Bebchuk 2000, p. 832.
[287] Roe 1983, p. 537-545.
[288] Roe 1983, p. 539-540.
[289] Roe 1983, p. 530.
[290] Bebchuk 1988, p. 790.
[291] Roe admits this himself. See: Roe 1983, p. 575-580.
[292] Bebchuk 1988, p. 790. This incentive would be most prevalent for the shareholders and junior creditors, who would gain most from a higher value of the corporation. Roe, however, disputes whether participants are sufficiently cohesive to really be able to manipulate the market price. See: Roe 1983, p. 579-580.
[293] Bebchuk 1988, p. 790.

which part of the value of RC each participant has to claim. Consequently, if the value of RC is described as V, the claim of a participant can be described as a function of V.[294]

Furthermore, Bebchuk assumes that RC has a given capital structure. In his proposal Bebchuk describes the possibility of giving RC an all-equity structure, with new shareholders being able to later change that capital structure. Or the possibility that the capital structure is set by an expert.[295]

The first step would then be to categorize the different claimants into different classes and give all these classes an equal amount of 'option-rights' in the new, reorganized company in return for their outstanding claims.[296] These rights provide the different classes of participants with different rights. For the most senior class each right is redeemable by the corporation for the pro rata fraction of the participants claim. Or – if the right is not redeemed – the holder of the right has a right to get his pro rata fraction of the RC's securities.[297] The rights related to the intermediate class provide its holders with the same rights as those of the senior class, only they will – in case of non-redemption – have to pay a price equal to their pro rata fraction of the total claim of the classes above. The most junior class has a non-redeemable right. It provides the holder with the right to purchase his pro rata fraction of the company's securities for a price equal to his pro rata fraction of the total claim of the classes above.[298]

An example may clarify the above.[299] Suppose there are three classes of participants. Class A with 100 senior creditors each owned € 1; class B with 100 junior creditors each owned € 1 and 100 shareholders - class C - each holding one share. At a certain point in time (T1) each senior creditor receives option rights. In the example above each creditor receives 1 option right.[300]

If RC consists of 100 RC units at the moment the options can be exercised (T2) than V is equal to 100 RC units. When one combines the different rights that belong to the option rights in the example it is clear that the obligation of RC is to distribute 100 RC at T2. If class C wishes to exercise its options it would have to submit € 200 to RC.[301] In return each member of class C will receive one RC unit and RC will redeem the option rights of class A and B. If no class C rights are exercised, class B can exercise their options for a total of € 100, redeem all rights of class A and receive 100 RC units. If neither class C or B exercises their rights, class A members will simply receive 100 RC units in total.[302] If only a part of the option rights distributed are exercised by a certain class then the received proceeds will be distributed pro rata to the higher ranking class. Participants will therefore never receive less

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[294] Bebchuk 1988, p. 783 and Bebchuk 2000, p. 834.
[295] Bebchuk 2000, p. 834.
[296] Bebchuk 1988, p. 782 and Bebchuk 2000, p. 834-835.
[297] These securities are called RC units. If RC has 100 RC units and, for example, 100 shares of common stock and 50 shares of common stock, each RC unit will consist of 1 common share and half a preferred share.
[298] Bebchuk 1988, p. 800-801. This way the old shareholders will be able to get their part of the equity back if they hold the opinion that the old corporation was worth more than the total amount of debt. For example, because the corporation was run inefficiently by inadequate management. In this situation creditors would be overpaid. That is, they get equity worth more than the total amount of debt. Bebchuk's proposal gives the old equity class an opportunity to correct for this. See also: Aghion, Hart and Moore 1994, p. 863-864.
[299] This example is derived from Bebchuk 1988. See: Bebchuk 1988, p. 781-782 et seq.
[300] With the different rights that belong to the different classes accorded to them.
[301] This is the sum of the total value of the claims of class A and B.
[302] Bebchuk 1988, p. 787.

than what they are entitled to and are not dependent on accurate market pricing. For this reason Bebchuk thinks his proposal superior to that of Roe.[303]

Although in Bebchuk's proposal participants do not depend on accurate market pricing, they may use the market to sell their option rights if they think the market is more accurate in pricing the value of their respective claims. For Bebchuk proposal holds that the option rights that are distributed to the participants of RC could be traded on the market between T1 and T2.[304] This means that if the market does not undervalue RC then participants will be able to sell their option rights right after T1 and capture the value of their entitlement.[305] If, however, the market does undervalue the value of the reorganized company then an option rights holder will still receive what he is entitled to.

For example, if class A thinks that the value of his right is € 0.90, but the market prices the right at € 0.50. Class A claimants will then not sell their option-rights and receive 100 RC units. Everything there is to give and that what they are entitled to.[306] Class A claimants will therefore not have anything to complain about.[307]

After T2 the company is out of insolvency and has an equity class. This equity class can appoint new directors that – as an agent of the shareholders – have an incentive to maximize the value of the corporation.[308] This maximization could be reached by continuing the corporation, but also by liquidation of the corporation.[309]

4.1.2 Possible complications

Bebchuk himself raises several complications with regard to his proposal. The most important of these complications are: i) the reinstatement of beneficial contracts, ii) secured claims and iii) concentration of claims.[310] Bebchuk, however, argues that these complications are no impediment to the introduction of his proposal.

With regard to beneficial contracts Bebchuk notes that it could be that defaulting on certain contracts is unfavorable for the participants in a corporation. For example, if the interest rate of a loan has risen after the loan was taken out. Bebchuk, however, does not see these contracts as a complication. The contracts that are favorable to the creditors should be specified in a reorganization plan. The contractual counterparties of the debtor with the reinstated contracts will not be affected by the bankruptcy and does therefore not participate in the division of option rights.[311]

With regard to secured claims Bebchuk simply argues that the statutory regime should be followed. If the law provides for a right of immediate payment then provisions to this end

[303] Bebchuk 1988, p. 789.
[304] Bebchuk 1988, p. 789.
[305] Bebchuk 1988, p. 789.
[306] Bebchuk 1988, p. 791.
[307] Except that the market does not function well. The option system proposed, however, cannot be blamed for this.
[308] The incentive for the (former) claimholders to maximize the value of the corporation stems from the fact that they are now the residual claimants of the corporation. See: Aghion, Hart and Moore 1994, p. 864-865.
[309] Bebchuk 2000, p. 837.
[310] Bebchuk 1988, p. 800-804.
[311] Bebchuk 1988, p. 802.

should be included in a reorganization plan.[312] Bebchuk does therefore not consider the problems related to secured claims to be a specific problem of his options approach.

Finally, it can be that one participant holds such a large part of the claims of the corporation that he ends up with a controlling block of shares in the reorganized company. Because he has a controlling block of shares these shares will be more valuable than the shares of the other participants. Bebchuk, however, argues that this problem can arise under any reorganization regime that divides securities between a corporation's participants.[313] In his opinion this problem could be solved by a mandatory sale of an amount of shares needed to reach a certain threshold.[314] This, however, would probably lead to depressed prices for the large blocks of shares that have to be sold mandatorily.[315] Which would be unfair to a creditor that happens to have a large claim.

4.2 Options theory 2.0

Aghion, Hart and Moore have used Bebchuk's option theory and have expanded it in several ways.[316] The main difference between their proposals is that a formal voting process over cash and non-cash bids solicited by the bankruptcy judge is conducted in the voting options proposal.[317] The basic idea behind their proposal, however, is the same as that of Bebchuk: use of the market to solve the valuation problem.

In the voting options proposal, just as in Bebchuk's, all debts are cancelled upon the declaration of bankruptcy of a corporation.[318] A judge will be appointed and will have to determine the size and relative priority of all claimants.[319] Directly after his appointment the judge will solicit bids for the corporation's assets and proposals for continuing the operations of the corporation.[320] These bids may consist of cash bids, but also of non-cash bids. A non-cash bid means that a party offers securities in the post-bankruptcy company and provides for reorganization of the company.[321] Combinations of cash and non-cash bids are also allowed. Aghion, Hart and Moore envision that the determination of relative size and priority of claims and the solicitation of bids will take three months.[322]

[312] Bebchuk 1988, p. 802-803. A reorganization plan would still be necessary under Bebchuk's proposal to determine some essential features of the reorganized corporation, such as the capital structure.
[313] Bebchuk 1988, p. 803. Compare: Roe 1983, p. 575-576. Roe also thinks the argument of controlling shareholders unconvincing against a (stock) market based approach. See also: Aghion, Hart and Moore 1992, p. 541-542.
[314] Bebchuk 1988, 803-804.
[315] Alexander Dilger, *The market is fairer than Bebchuk's scheme,* Diskussionspapiere Ernst-Moritz-Arndt-Universität Greifswald nr. 9, 20-21 (2000).
[316] Aghion, Hart and Moore 1992 and Aghion, Hart and Moore 1994. The proposal was in turn further elaborated on in: Hart, La Porta Drago, Lopez-de Silanes en Moore 1997.
[317] Bebchuk does not see the introduction of a formal vote as the major improvement of the Aghion, Hart and Moore proposal over his own, but the fact that the bids must be already submitted before option rights can be traded. Bebchuk 2000, p. 837.
[318] Aghion, Hart and Moore 1992, p. 533 and Aghion, Hart and Moore 1994, p. 862.
[319] Aghion, Hart and Moore 1992, p. 533 and Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, p. 464.
[320] Aghion, Hart and Moore 1992, p. 533; Aghion, Hart and Moore 1994, p. 862 and Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, 464.
[321] Aghion, Hart and Moore 1992, p. 533; Aghion, Hart and Moore 1994, 862 and Hart, La Porta Drago, Lopez-de Silanes and Moore 1997, p. 464. An example of a non-cash bid is if management bids to 'buy' each share in the bankrupt corporation in return for one share in the reorganized corporation.
[322] Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, p. 464.

In the most extensive proposal the corporation - after the three months are up - issues 100 Reorganization Rights (RRs) and the judge reveals the bids received.[323] The issued RRs are initially allocated to the senior creditors, but the other claimants have the possibility to acquire RRs by exercising option rights in the inside auction. These RRs provide for the right to vote after all auctions have been concluded. By initially allocating the RRs with the senior creditors it is assured that no junior creditor will receive payment before all senior creditors have been fully paid.[324]

After this inside auction a public auction will be held in which outsiders can buy RRs from those who hold the RRs at that point in time.[325] This will provide creditors with an opportunity to sell their RRs for cash. Aghion, Hart and Moore envision that the inside and public auction together will take around one month to conclude.[326]

The idea behind having an inside auction before a public auction is that if the markets are imperfect, outsiders could overbid the corporation's original creditors, while still receiving RRs for a price lower than their true value. The inside auction tries to prevent this by giving insiders a preferential right to buy RRs.[327]

After the auctions have been concluded the RR holders meet and vote on what they consider to be the best offer received by the judge at the end of the first three months.[328] This proposal can consist of reorganizing of the corporation, but also of liquidating it. Just like in Bebchuk's proposal all RR holders are the residual claimant of the reorganized company and have an incentive to maximize the value of the company, thus ensuring that they select the best offer at hand.

4.3 The costs of the option approach

Bebchuk and Aghion, Hart and Moore have drawn up elegant proposals to replace Chapter 11 of the U.S. Bankruptcy Code. There are, however, several objections that can be raised in relation to their proposals.

Disputed claims

A major problem with the options proposals - just as with a mandatory auction regime - is that these proposals do not provide a method to determine the relative size and priority of the different claims; a key feature of an administrative reorganization procedure.[329] Both Bebchuk and Aghion, Hart and Moore quite easily assume that assessing size and priority of the claims in a bankruptcy will be done in a clean and speedy manner.[330] Reality, however, is different and hardball litigation is certainly not unthinkable in larger bankruptcies.

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[323] Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, 465.
[324] Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, 469. This feature is argued to be an improvement of Bebchuk's proposal.
[325] Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, 465. See also: Agion, Hart and Moore 1992, p. 535.
[326] Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, 465-466.
[327] Hart, La Porta Drago, Lopez-de Silanes en Moore 1997, 467.
[328] Aghion, Hart and Moore 1992, p. 536 and Hart, La Porta Drago, Lopez-de Silanes and Moore 1997, 466. Bebchuk contends that the fact that bids must already be submitted before the RRs are traded is a valuable contribution to his proposal. This provides the creditors with additional information which they can take into account in their decision whether to exercise their option or not. See: Bebchuk 2000, p. 837.
[329] Baird 1997, p. 5; Lubben 2001, p. 275.
[330] Bebchuk 1988, p. 798 and Aghion, Hart and Moore 1992, p. 534.

Aghion, Hart and Moore do propose a solution for the problem of disputed claims.[331] They state that if, for example, only 10% of the claims is disputed the option approach would be used for the 90% of undisputed claims. Any cash generated during the restructuring is held in escrow by the judge. When the claim disputes are resolved the newly acknowledged claims would receive an equity stake in the reorganized company and the money held in escrow could be distributed accordingly.

This solution may work when only a small percentage of the claims is disputed. Aghion, Hart and Moore, however, do not explain what happens if a large percentage of the claims of a debtor is disputed or if there is one creditor with a claim that is a large claim relative to the total amount of claims. Furthermore, this solution fails to take into account that creditors cannot always be neatly divided into their levels of priority.[332]

Bias of failures in estimation

The lack of a method to determine size and priority of the different claimants is not the only problem with an option approach of bankruptcy. There is also the problem of failures in estimation by junior claimants.

Participants in the bankruptcy will have to estimate the value of the corporation. Their estimates, however, will not always be correct. Especially junior claimants are likely not to receive what they are entitled to. This can be the case both with regard to over and underestimation. In case of an overestimation of the value a junior claimant will lose by exercising his option even though the true value of the option lies below his estimate.[333] A junior claimant can also underestimate a corporation's value. This means he loses when he does not exercise his option because he estimates the value of the share to be lower than the exercising price even though the true value is higher.[334] The consequence of a wrong estimation by the junior claimants is that the senior creditors will either receive too much money or too many shares.[335] This is a violation of the absolute priority rule.

Transaction costs

Another point that should be taken into account are the transaction costs involved in using an option approach. There are costs involved in offering the options. These are typically administrative costs made by the debtor and the costs of the banker that conducts the offering and the transfer of the options.[336] Other costs would have to be made to raise the capital necessary to exercise the options.[337] Since the junior creditors would not need capital to buy back their own interest in the corporation, but only that of the higher ranking creditors the amount of capital is less than the capital needed under a mandatory auction regime. The costs will be considerable nonetheless.[338]

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[331] Aghion, Hart and Moore 1992, p. 541.
[332] Lubben 2001, p. 275-276. Lubben gives the example of a unsecured creditor (creditor 1) that is subordinated to another unsecured creditor (creditor 2), because of a subordination clause. Other unsecured creditors, such as trade creditors (creditor 3), will not be bound by such a subordination. Creditor 2 is therefore subordinated to creditor 1, but not to creditor 3. At the same time creditor 3 is not subordinated to creditor 1.
[333] Alexander Dilger, *Forced to make mistakes: reasons for complaining about Bebchuk's scheme and other market-oriented insolvency procedures*, 21 Eur. J. Law. Econ. 79, 85-86 (2006).
[334] Dilger 2006, p. 85-86.
[335] Dilger 2006, p. 85.
[336] Adams 1991, p. 156; Adler 1993A, p. 320.
[337] Adams 1991, p. 152-153.
[338] Adams 1991, p. 153.

Information and illiquidity

Bebchuk himself raises two possible objections that can be made against his proposal: a change in the available amount of information and the necessity to invest financial resources.[339]

It could be argued that the amount of information needed to determine what the value of a corporation is, and as a consequence, what a claim holder should do with his option rights is increased with the introduction of Bebchuk's proposal. Bebchuk argues that this argument is invalid, since under an administrative reorganization procedure the participants also have to bargain under their own estimate of the value of the corporation.[340] Furthermore, there is no reason to assume that participants have less information available. Rather, they will have an additional source of information available: the market.[341]

The market, however, will only be a helpful source of information if the options are not undervalued.[342] A participant will have to decide on his own whether to exercise his options and therefore he will need to value the company. Furthermore, under the option approach each participant will need to make his own estimate. This way an advantage of an administrative reorganization procedure – collective gathering and sharing of information – is lost.[343]

Second, with regard to financial resources Bebchuk recognizes that some participants would need to invest, before they can receive that what they are entitled to.[344] They may not wish or be able to invest in the corporation again. Bebchuk reasons that this objection is unconvincing. Participants will have their right redeemed by the corporation or can sell their option right on the market in most cases. In other cases, when a participant does not have the financial resources to make the necessary investment, he could borrow the necessary amount.[345] This assertion, however, can also be questioned. There will be claimants that have substantial outstanding credit and who would run the risk of themselves becoming insolvent because they lose their claims.[346] Furthermore, claimants will not always be able to sell their options. This is especially true for small companies, for which it is questionable that a liquid trading market will exist.

Aghion, Hart and Moore: no real improvement

The Aghion, Hart and Moore proposal aims to form an improvement of that of Bebchuk. It aims to do so by, for example, allowing non-cash bids for the bankrupt corporation to eliminate the problem of liquidity constraints for bidders for the corporation.[347] However, other problems such as transaction costs and disputed claims are not solved by the Aghion, Hart and Moore proposal. Moreover, the contended main improvement of Bebchuk's

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[339] Bebchuk 1988, p. 795-797 and Bebchuk 2000, p. 839-840.
[340] Bebchuk 1988, p. 795 and Bebchuk 2000, p. 840.
[341] Bebchuk 2000, p. 840. An individual creditor, however, may have less information available, because information is gathered on an individual basis. However, this collective action problem does not, according to Bebchuk, decrease the total amount of information available. See: Bebchuk 1988, p. 795-796.
[342] Dilger 2006, p. 83-84.
[343] Dilger 2006, p. 85.
[344] Bebchuk 1988, p. 796 and Bebchuk 2000, p. 839.
[345] Bebchuk argues that the participant could pledge his option rights to borrow the necessary funds. See: Bebchuk 2000, p. 839.
[346] Dilger 2006, p. 86.
[347] Baird 1997, p. 9.

proposal - the allowance of both cash and non-cash bids for the corporation - is no real improvement in this respect.

With regard to cash bids the problem is that the winning bid has to be approved by the RR holders.[348] In a normal first-price auction the seller would sell the corporation to the highest bidder. A bidder would only gain from the auction if he bids lower than the true value of the corporation. In the Aghion, Hart and Moore proposal the RR holders can use this fact as a way to gather information on a potential maximum price. They could offer the corporation to a bidder for a price nearest to their valuation.[349] A bidder would anticipate this strategy and only bid a price that does not reveal his true valuation. This would result in no or only low cash bids.[350]

Non-cash bids on the other hand are unnecessary.[351] These bids regard the voters as the new owners of the corporation and concern the structure of the corporation.[352] Such non-cash bids provide voters with an opportunity to base their vote on non-pecuniary aspects, such as the choice between different management teams or different capital structures. There is no reason, however, why shares cannot be directly allocated according to the options theory as advanced by Bebchuk and have the new shareholders make the decisions involved in the different non-cash bids.[353] Directly allocating shares takes away the restriction of being able to choose only among the different bids. Furthermore, no special laws for the protection of minority voters are necessary.

Part C

The way forward: repeal or change?

1. The advantage of the alternatives: correct valuation

Because a value cannot be determined precisely at the real value of the debtor there is room for bargaining and bias under an administrative reorganization procedure. This valuation problem can be illustrated by the judgment of the District Court in *Citibank v. Bear*:

"My final conclusion as to the value of the company is that it is worth somewhere between $90 million and $ 100 million as a going concern, and to satisfy the people who want precision on the value, I fix the exact value of the company at the average of those, $ 96,856,850, which of course is a total absurdity that anybody could fix a value with that degree of precision, but for the lawyers who want me to make a fool estimate, I have just made it."[354]

This begs the question whether the value of the debtor should be determined by a judge or by someone else. The alternatives for the administrative reorganization procedure discussed in this Article argue that it should be someone else. They put their faith in 'the market'.[355] In a functioning market this provides for a more accurate way of valuing the debtor. However, the

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[348] Dilger 1999, p. 155.
[349] Dilger 1999, p. 156. Dilger assumes some bargaining power at the side of the RR holders.
[350] Dilger 1999, p. 156.
[351] Dilger 1999, p. 156.
[352] Other non-cash bids would only allow a dominant voter to redistribute value away from minority voters. Dilger 1999, p. 156.
[353] Dilger 1999, p. 156.
[354] Citibank v. Baer, 651 F.2d 1341, 1347 (10th Cir. 1980), quoting district court ruling.
[355] It is noted that the menu approach also has an 'administrative reorganization procedure" option.

advantage of a valuation that is more precise should be weighed against the costs that are involved in introducing a market valuation.

2. The drawbacks of the alternatives

Just as with the valuation problem the problem with alternatives for the administrative reorganization procedure discussed in this Article are mainly a consequence of the fact that the world - including the markets - is imperfect.

The contractual alternatives to the administrative reorganization procedure, for example, fail to take into account that in reality claimants cannot be divided in a textbook manner. Furthermore, the contractualist proposals all seem to assume that assets can be sold immediately for its true value. Sometimes, however, selling assets for their true value takes time, effort and money. At the same time, it can be that the assets of the debtor have to be sold very shortly after the debtor is declared bankrupt. But in the Chameleon and Contingent Equity proposals the creditors would first have to decide collectively whether to default again or raise money by means of issuing equity. Furthermore, they would have to decide on whether to keep existing management in place. This would all cost time that the debtor does not have. Finally, with regard to contractual structures the transaction costs should not be underestimated. Drawing up contracts and covenants, reviewing them and litigating them costs money. Sometimes a lot of money.

With regard to auctions it is noted that the need for a valuation would not be completely obviated. For example, if the claims of a secured creditor are limited to the value of certain assets of the debtor. Furthermore, a mandatory auction can result in a suboptimal yield, because of a lack of competition. This can result in fire sales.

With regard to the options approach it can be questioned whether this system would really work in practice. For example, Bebchuk does not provide for a satisfying solution for large amounts of disputed claims. Furthermore, creditors will have to pay to get what they are entitled to. Bebchuk proposes that creditors could just borrow the funds. But borrowing also costs money and it is questionable whether creditors would be willing to cooperate with such a procedure. Finally, conducting the options procedure takes time. It can be, however, that the assets of the debtor have to be sold within a few days. Just like the contractual solutions, options theory does not provide for a way to do this.

3. How high are the costs of an administrative reorganization procedure really?

The critics of the administrative reorganization procedure - and Chapter 11 in particular - have argued that the costs of such a procedure are not only related to the valuation problem. According to them, direct costs, the lack of speed and the perverse incentives for management also make an administrative reorganization procedure inefficient. But are their arguments valid?

3.1 Direct costs

With regard to direct costs there have been several empirical studies. In 2000 Lubben found that the direct costs of Chapter 11 were on average 0.87% of total firm size (assets plus debts). When prepackaged bankruptcies were removed the direct costs were found to be

1.20%.[356] In the same year Lawless and Ferris performed a study on small bankruptcies. They established the median of costs of Chapter 11 to be 3.5% of debtor assets.[357]

In 2008 Lubben performed another study on the direct costs of Chapter 11.[358] He reported the costs of professional fees to be 4 to 4.5% for both a random dataset of 945 cases and a dataset containing only 99 big cases. The year before Lubben had asserted that more than 60% of attorneys retained in his sample were not bankruptcy specialists.[359] According to Lubben this suggested that a large amount of direct costs incurred during the bankruptcy are exogenous to Chapter 11.

In 2010 Lubben wrote his dissertation on the direct costs of Chapter 11.[360] In his book he reported that debtor professionals were on average responsible for 63.1% of total costs. Creditor committees were the cause of 22.5% of total Chapter 11 costs. Lubben also found that a prepackaged Chapter 11 case was not significantly cheaper in terms of direct costs than a regular Chapter 11 case. He hypothesizes that this can be explained by the shifting of costs to the pre-bankruptcy period.[361] Lubben further concluded that complexity and fee structure of the professionals retained are the key determinants of costs.

The amount of empirical research that is done on direct costs of Dutch bankruptcies is limited. This makes the work of Couwenberg and Lubben the more interesting.[362] In their work they compare the costs of business bankruptcy in the United States and the Netherlands.[363] They conclude that Dutch bankruptcies, on average, cost 3% of debtor size and that cases from the United States cost 12% of debtor size.[364] Couwenberg and Lubben argue, however, that in the United States a large part of the costs of Chapter 11 are unrelated to the actual insolvency process. In the United States professionals retained by the debtor perform a much broader array of services than in the Netherlands. Therefore Couwenberg and Lubben limit the direct costs of bankruptcy to that of the lead counsel for the debtor and accountants retained by the debtor.[365] Once this is done the costs of bankruptcy in the United States and the Netherlands are at nearly the same level. Couwenberg and Lubben suggest that the difference between direct costs in the United States and the Netherlands is caused by non-bankruptcy related professionals that are used in American bankruptcy.[366] These are costs that a debtor would have also incurred outside of bankruptcy when there would be, for example, a take-over.

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[356] Stephen J. Lubben, *The direct costs of corporate reorganization: an empirical examination of professional fees in large Chapter 11 cases,* 74 Am. Bankr. L. J. 509 (2000). Measured as a percentage of assets the direct costs were respectively 1.8% and 2.5%.

[357] Stephen P. Ferris and Robert M. Lawless, *The expenses of financial distress: the direct costs of Chapter 11,* 61 U. Pitt. L. Rev. 629 (2000).

[358] Stephen J. Lubben, *Corporate reorganization and professional fees,* 82 Am. Bankr. L. J. 77 (2008).

[359] Stephen J. Lubben, The microeconomics of Chapter 11 - Part 1, 4 Int. Corp. Res. 31 (2007A) and Stephen J. Lubben, The microeconomics of Chapter 11 - Part 2, 4 Int. Corp. Res. 87 (2007B)

[360] Stephen J. Lubben, Measuring the costs of Chapter 11. Professional fees in American corporate bankruptcy cases (2010A).

[361] Lubben 2010A, p. 42. The costs made in the pre-bankruptcy period can be measured because attorneys are required to disclose pre-filing compensation received from the debtor. 11 USC § 329.

[362] O. Couwenberg and Stephen J. Lubben, *The costs of Chapter 11 in context: American and Dutch business bankruptcy,* 85 Am. Bankr. L. J. 63 (2011).

[363] Since Dutch bankruptcy law has no separate procedure for reorganization, they could only report on the direct costs of Dutch bankruptcies in general. With regard to the United States they use data on Chapter 11 cases.

[364] Debtor size is defined as the sum of assets and liabilities divided by two. See: Couwenberg and Lubben 2011, p. 75.

[365] Couwenberg and Lubben 2011, p. 76.

[366] Couwenberg and Lubben 2011, p. 78.

When overlooking the evidence it therefore seems that the direct costs of an administrative reorganization procedure are not disproportionately high. Furthermore, a part of the costs - especially in a Chapter 11 procedure - would also have been incurred in a restructuring outside of bankruptcy.

3.2 Speed

Another question is whether, as some critics have argued, the length of an administrative reorganization procedure is a good proxy for costs? With regard to Chapter 11 empirical research has shown that the time that a corporation spends on this procedure has no relation to the costs incurred.[367] In this respect it is interesting that Warren and Westbrook have demonstrated that Chapter 11 is quite efficient in sorting out the 'winners' from the 'losers'. They have shown that cases destined for liquidation are disposed of rather quickly under Chapter 11.[368] This is good, because unnecessary costs are incurred in efforts to reorganize a corporation destined for liquidation. Under Dutch bankruptcy law the costs of a bankruptcy procedure are dependent rather on the effort and time it takes to sell the assets than the length of the procedure.[369]

What is more, say we do accept that speed is a good proxy for costs, is it then really true that Chapter 11 takes a lot of time, allowing managers to postpone an inevitable liquidation in attempt to turn it into solvency? Empirical research has demonstrated that the length of the Chapter 11 procedure has diminished over the course of the past decades. Where Frank and Torous report an average duration of 3.7 years for a Chapter 11 procedure, Brish, Welch and Zhu report a duration of around 2 years.[370] In 2009 Westbrook and Warren demonstrated an average time of eleven months for Chapter 11 procedures.[371] In their sample the typical case took nine months, but this was raised to eleven months on average because of a handful of long cases. After two years almost all cases were resolved. Under Dutch law the average bankruptcy proceeding takes longer to complete: on average 25 months.[372] This is, however, the duration of liquidation and reorganization cases combined. It is unclear how long reorganization cases take on average to complete. Furthermore, in the cases studied all the assets were sold after 3.4 months on average.[373] It therefore seems that the speed of an administrative procedure is not a very good measuring stick for costs and that, even if it were a good measuring stick, administrative reorganization procedures generally do not last disproportionally long.

3.3 Perverse incentives for management

With regard to the perverse incentives for management, the critique of the administrative reorganization procedure implies that the governance regime in bankruptcy falls short. However, a governance regime in Chapter 11 has taken posture over the years. First of all, the law does not give unfettered control over the corporation or the reorganization process to

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[367] Lubben 2008 and Lubben 2010A.
[368] Eizabeth Warren and Jay L. Westbrook, *The success of Chapter 11: a challenge to critics,* 107 Mich. L. Rev. 603 (2009).
[369] O. Couwenberg and A. de Jong, *Costs and recovery rates in the Dutch liquidation-based bankruptcy system,* 30 Eur. J. of L. and Econ. 105, 119 (2008).
[370] J.R. Frank and W.N. Torous, *An empirical investigation of U.S. firms in reorganization,* 44 J. of Fin. 747 (1989) and A. Bris, I. Welch and N. Zhu, *The costs of bankruptcy: Chapter 7 liquidation versus Chapter 11 reorganization, 59 J. of Fin. 1253 (2006).*
[371] Warren and Westbrook 2009.
[372] Couwenberg and De Jong 2008.
[373] Couwenberg and De Jong 2008.

management during a Chapter 11 procedure. Control over the corporation is limited by the fact that consent of the court is necessary for use, sale and lease of property and obtaining credit outside the 'ordinary course of business'.[374] The court also supervises the reorganization to determine whether the debtor should retain the exclusive right to propose a plan, which has been limited under BACPCA to 18 months.[375] Management will also be supervised by a creditor committee, if one is appointed.[376]

Secondly, over the last years Chapter 11 has seen a rise of effectuating governance by means of contract control.[377] This is mainly done by means of debtor-in-possession financing. Corporations need money to successfully reorganize. After being declared bankrupt a corporation can arrange for this money by entering into a contract with a lender.[378] Usually the contracts for the financing have already been written at the time a corporation files for bankruptcy. In these contracts the lender can lay down strict covenants with regard to what management can and cannot do. The lender, for example, can stipulate that a reorganization plan should be filed by a certain date, effectively precluding management from endlessly trying to reorganize with the hope of turning the corporation back to solvency. The lending contract can also provide for the appointment of a Chief Restructuring Officer, when the lender deems pre-bankruptcy management insufficiently capable of reorganizing the corporation. Contracts of the kind described above effectively give the lender that provides for the debtor-in-possession financing control over a large part of the reorganization process. This severely reduces the contended perverse incentives for management under a reorganization procedure.

Finally, the argument that management would have a reorganization bias, because they continue to keep their job under this procedure has proven to be unjustified. Empirical research has shown that management turnover of bankrupt corporations is quite high.[379]

Under Dutch law a trustee will always be appointed and the debtor will incur costs for his work.[380] The fact that management knows that it will not be in charge of the debtor after filing for bankruptcy may reduce the incentive to timely file for bankruptcy. At the same time this means that the argument expressed by the American critics of the administrative reorganization procedure that management can protract a reorganization procedure longer than is optimal or take unjustified risks with the debtor's assets is not valid under Dutch law.

3.4 The valuation problem: an evolution

As described above, the administrative reorganization procedure has evolved over the years. This also goes for the valuation problem. American bankruptcy practitioners and scholars

[374] 11 USC § 363 and 11 USC § 364. See: Harvey R. Miller, *The changing face of Chapter 11: a reemergence of the bankruptcy judge as producer, director and sometimes star of the reorganization passion play,* 69 Am. Bankr. L.J. 431, 447 (1995) and Christopher W. Frost, *Running the asylum: governance problems in bankruptcy reorganizations,* 34 Ariz. L. Rev. 89, 125 (1992).
[375] 11 USC § 1121
[376] Which will almost always be the case in large bankruptcies.
[377] See extensively: David A. Skeel, *Creditor's ball: the 'new' new corporate governance in Chapter 11,* 152 U. Pa. L. Rev. 917 (2003), David A. Skeel, *The past, present and future of debtor-in-possession financing,* 25 Cardozo L. Rev. 1905 (2004) and Harvey R. Miller, *Does Chapter 11 reorganization remain a viable option for distressed businesses for the twenty-first century,* 78 Am. Bankr. L.J. 153 (2004).
[378] 11 USC § 364.
[379] Ethan S. Bernstein, *All's far in love, war and bankruptcy? Corporate governance implications of CEO turnover in financial distress,* 11 Stan. J.L. Bus. & Fin. 298 (2006) and Kenneth M. Ayotte and Edward R. Morrison, *Creditor control and conflict in Chapter 11, 2009 J. Legal Anal. 511.*
[380] § 14 DBC.

have especially seen a rise in the use of the 363-sale and the prepackaged reorganization. These options - next to the traditional reorganization plan - provide for an opportunity to choose the most suitable path for a reorganization.

When both the value of the assets as well as the value of the claims are unknown at the start of a bankruptcy procedure the traditional reorganization plan can be used. Parties can bargain over what they perceive to be the value of the debtor and over what their respective claims in relation to the debtor are. Possible perverse incentives for management to drag out the reorganization are diminished by the high turnover rate of management after bankruptcy filings and the conditions under which debtor-in-possession financing is provided.

If the value of the assets is clear, but the value and relative priority of the claims is not, a 363-sale can be used.[381] This kind of sale has the advantages of a mandatory auction regime, but does not oblige a debtor to use it if, for example, there is a complete lack of competition and the debtor is better off being sold to its own claimants.

In a 363-sale the assets of the debtor are sold off outside the ordinary course of business and free and clear of liens.[382] Usually the debtor will seek a 'stalking horse' that is prepared to place a floor price for the debtor's assets. Generally speaking this stalking horse is entitled to a 'break-up fee' if he does not win the bidding process. Then bids are solicited and the winning bid is filed with the bankruptcy judge for approval. For a judge to give approval to a proposed 363-sale the bid and the sale itself have to meet certain criteria. In *In re Gulf Coast* the court set out thirteen factors to be taken into consideration in reviewing a proposed sale.[383] One of the most important factors of which is whether there is a 'substantial business reason' for conducting a 363-sale over the Chapter 11 procedure. This business reason is usually argued to be present by stating that there is a risk of substantial value depreciation of the debtor's assets if there is no speedy sale. The number of 363-sales has risen substantially over the last years. A famous example of such a sale is the 2008 sale of the brokerage activities of Lehman Brothers to Barclay's Capital in just five days.

The Dutch equivalent of the 363-sale is the asset transaction (*activatransactie*).[384] Under this kind of transaction the trustee sells a part or all of the assets of the debtor to a third party.[385] In an asset transaction the trustee negotiates over an agreement with one or more potential buyers. Once an agreement is reached the supervisory judge has to approve of the proposed sale. There is no statutory law governing the guidelines for approval of the sale by the supervisory judge. However, a trustee will generally have to file a standard form that has been drawn up by the Association of Supervisory Judges in bankruptcies (*Recofa richtlijnen*).[386] This form consists of ten questions regarding the proposed sale to ensure that the price reached under the proposed agreement is the highest price possible. Creditors have no influence on the procedure.[387]

If the value of both the assets and the claims of the debtor are known a debtor can opt for a 'prepack'. In a prepack a debtor reaches agreement with its creditors on a reorganization plan

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[381] 11 USC § 363.
[382] 11 USC § 363(b) and 363 (f).
[383] In re Gulf Coast Oil Corporation, 404 B.R. 407 (Bankr. S.D. Texas 2009).
[384] § 101 and § 176 DBC.
[385] This third party can also be existing management or the old shareholders.
[386] The form is annex 14 of the Recofa richtlijnen.
[387] The only exceptions are the cases where a creditor committee has been appointed. The trustee will then have to ask this committee for (non-binding) advice. § 69 and 78 DBC.

and solicits the necessary votes for the plan prior to filing for bankruptcy.[388] A prepackaged plan can only be confirmed if a disclosure statement has been filed, the requirements for creditor approval that are applicable in Chapter 11 are met and the creditors and equityholders - insofar as they are impaired by the plan - did not have an unreasonably short period of time to vote on the plan.[389]

The Dutch Bankruptcy Code has no explicit provisions for a prepackaged bankruptcy. Rather, it makes a prepackaged reorganization plan impossible by stating that votes for a proposed reorganization plan can only be solicited directly after the meeting of creditors.[390] This means that there is no room for a prepackaged reorganization plan, but only for a prenegotiated one. This may prevent an efficient reorganization from happening, because of the fact that the voting over the plan takes too much time. The Dutch Bankruptcy Code should be amended on this point.

Part D

General conclusion

Do not throw away old shoes before you have new ones. The same goes for a bankruptcy procedure. In this Article I have argued that a repeal of the administrative reorganization procedure in the United States and the Netherlands is unwarranted. We are better off by simply fixing the shortcomings of the current procedure. I hope that this point of view will be followed by American and Dutch legislators.[391]

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[388] 11 USC § 1126(b) and Federal Rules of Bankruptcy Procedure 3018(b).
[389] 11 USC § 1126(b), § 1126(c) and FRBP 3018.
[390] § 139 DBC.
[391] In America the American Bankruptcy Institute recently installed the Commission to Study the Reform of Chapter 11. The findings of this Commission will be presented to Congress. In 2007 the Dutch *Commissie Insolventierecht* launched the Predesign Insolvency Law (*Voorontwerp Insolventiewet*). This predesign offered a complete draft for a bill. The Minister of Justice has stated that the Dutch government has no plans to submit a bill for a completely new bankruptcy code in the near future based on this predesign. He did, however, invite parties to submit proposals for reform of the current Bankruptcy Code. See: Parliamentary Papers 2010-2011, Appendix to the Proceedings, 1014.