CAN THE SAUVEGARDE REFORM SAVE FRENCH BANKRUPTCY LAW?: A COMPA

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### STUDENT NOTE

## CAN THE SAUVEGARDE REFORM SAVE FRENCH BANKRUPTCY LAW?: A COMPARATIVE LOOK AT CHAPTER 11 AND FRENCH BANKRUPTCY LAW FROM AN AGENCY COST PERSPECTIVE

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I.	Introduction				
II.					
III.	AG	ENC	Y COSTS OF DEBT IN THE CONTEXT		
	OF	AN I	Insolvent Firm	261	
	A.	Ass	set Substitution Problem	263	
			her Agency Costs of Debt		
	C.	Age	ency Costs Ultimately Borne By Shareholders	267	
IV.			DEVIATING FROM ABSOLUTE PRIORITY TEMPER		
	AG	ENC	Y CONFLICTS IN THE CONTEXT OF		
	Сн	APT	er ii Reorganizations?	268	
	A.	Em	pirical Observations	268	
			octrinal Considerations		
		1.	The Debtor in Possession and the Difficulty of		
			Appointing a Trustee	270	
		2.			
			Plan of Reorganization	272	
		3.	Continued Control over Operation and		
			Business Decisions	272	
		4.	Information Asymmetry and Thorny		
			Valuation Problems	273	
		5.	A Note on the 2005 U.S. Bankruptcy Reform	276	
	C.	No	rmative Implications	276	
V.			IPARATIVE APPROACH: LOOKING TO THE		
	French Law Model				
	A.		e Mechanics of French Bankruptcy Law		
		1.	Commencing the Case	285	
		2.	The Observation Period and		
			Administrator Appointment	287	
		3.			
			Implementing Plan of Rehabilitation	289	

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		4. Penalties and Sanctions for Managers	
		and Equityholders	292
	В.	French Bankruptcy Law and Agency Conflicts	
		Moving Towards Twilight?: Proposed French	
		Reforms Emulate Chapter 11 Structure	297
VI.	Co	NCLUSIONS	

La relation franco-américaine est, à certains égards, schizophrénique. Nous ne cessons de critiquer les États-Unis d'une manière systématique, caricaturale, parfois ridicule, mais nous ne perdons jamais une occasion d'imiter, voire de singer, notre plus vieil allié.<sup>1</sup>

#### I. Introduction

This Note will attempt to explain the intersection of agency costs and bankruptcy law, looking first to general agency problems involved when firms are insolvent and moving next to discussions of how U.S. Chapter 11 and French bankruptcy laws attempt to address these problems. First, I will attempt to articulate the relationship between agency costs and (1) debtor control over the firm during Chapter 11 reorganizations and (2) deviations from the absolute priority rule in Chapter 11. Specifically, I will argue that creditors voluntarily accede to plans proposed by management that impair the same creditors' legal entitlements, and that this otherwise irrational behavior is an attempt to reduce the agency conflicts inherent in the creditor-management and creditor-shareholder relationships of an insolvent firm.

I will then compare the U.S. Chapter 11 model of bankruptcy with the French redressement judiciaire procedures, which banish management and equity stakeholders in favor of a state-run rehabilitation. The French laws address agency conflicts by assessing penalties on directors for malfeasance, but ultimately they exacerbate the agency conflict between management and debt and sabotage the pro-employment and pro-rehabilitation goals of French bankruptcy. As we look to the French system, the positive elements of Chapter 11 will become clearer, and we will be able to reconstruct the purpose of Chapter 11—even with its absolute priority deviations—as a pragmatic solution to unavoidable agency

<sup>1.</sup> Translation: "The Franco-American relationship is, in many respects, schizophrenic. We never cease our systematic, caricatured, at times ridiculous critique of the United States, but we never lose a chance to imitate—indeed, to ape—our oldest ally." Paul Giacobbi, 161st session of the Assemblé Nationale, Mar. 1, 2005, available at http://www.assembleenationale.fr/12/cri/2004-2005/20050161.asp (last visited Nov. 2, 2005) (comenting on the new French Sauvergarde bankruptcy Law).

problems resulting from debt. Ultimately, I will describe the recently-created sauvegarde procedure in France—a dramatic departure from current French bankruptcy laws—as a substantial step toward a Chapter 11 framework and a welcome development from an agency perspective.

Part II will examine the benefits of the absolute priority rule. Part III will address the agency conflicts—and their costs—of debt in the insolvency and bankruptcy context. Next, in Part IV, I will explore the empirical, doctrinal, and normative elements of absolute priority deviations in Chapter 11 bankruptcies. In particular, I will examine the U.S. Bankruptcy Code in some detail, pointing out its bias in favor of management as well as the justifications for such bias. Finally, in Part V I will similarly analyze the French civil law insolvency regime, uncover the structural agency dilemmas, and evaluate recent proposed reforms to the French system that make management and equity more active interlocutors in the discussion that will determine the firm's future.

### II. THE EXANTE BENEFITS OF THE ABSOLUTE PRIORITY RULE

The absolute priority rule (APR) holds that prepetition contractual entitlements will be respected in bankruptcy proceedings. Under a strict application of the absolute priority rule, senior creditors must be fully compensated before junior creditors receive anything. Junior creditors, then, must be compensated the full value of their claims before anything goes to the residual claimants, and so forth. Equity, of course, is always paid last. The U.S. Supreme Court has quoted approvingly from a case explaining that the APR "provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a Chapter 11] plan." For an insolvent firm whose liabilities exceed its assets' value (even taking into account salvaged going concern value), the absolute priority rule mandates a zero distribution to equity holders.

When bankruptcy regimes respect the contractual arrangements of debtors and creditors, and do not interfere with their bargained-for entitlements, an argument may be made that the system is ex ante efficient. That is, if lenders can lend freely without taking into account the possibility that a bankruptcy court may impair their contractual rights, they will be able to offer more favorable yields, maturities, and interest rates to their debt, as well as require fewer restrictive covenants in their loan agreements. The net effect of such consequences is a lower cost of

<sup>2.</sup> Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) (quoting from the homonymous Eighth Circuit opinion, from which the appeal originated, *In re* Ahlers, 794 F.2d 388, 401 (8th Cir. 1986)).

borrowing for borrowing firms and increased firm values. Conversely, deviations from absolute priority, because they expropriate wealth from debtholders to shareholders, have *ex ante* inefficiency effects and increase the cost of capital and the costs of bankruptcy to corporations.<sup>3</sup> Lenders will also be able to lend less money, as the resultant increased cost of capital will inevitably price some borrowers out of the market.

Such a discussion undoubtedly simplifies the scenario, since *ceteris* paribus the cost of equity should decrease in lockstep with the increased cost of debt. Equity will pay for pawning off bankruptcy risk onto debtholders in the form of higher interest rates. Absent some justification for APR violations, however, the bankruptcy litigation/restructuring process would amount to an expensive deadweight loss, and its effect would be simply to transfer risk and value from one group of security-holders to another.

Empirical investigations, however, consistently confirm what bank-ruptcy professionals have known all along: bankruptcy courts are always approving plans that deviate from absolute priority, usually in favor of equity holders. Why bankruptcy courts and Chapter 11 plans tinker with prepetition terms of debt contracts—and whether their reasons are efficiency-enhancing or fair —are questions that have received ample treatment in the literature. Commentators are far from united in their judgment of the desirability of APR deviations, but most agree that by awarding equity holders and management a stake in a bankrupt company, irrespective of their prebankruptcy contractual entitlements, the bankruptcy regime can reduce agency costs incident to an insolvency scenario. Seen in this light, APR violations may be a positive economic factor, inasmuch as they simultaneously lower the cost of equity by granting equity holders a stake in an insolvent company and reduce the agency costs that debtholders must bear, thereby reducing the cost of borrowing.

<sup>3.</sup> For some representative discussions of this much-discussed phenomenon, see Michael C. Jensen, Corporate Control and the Politics of Finance, 4 J. APP. CORP. FIN. 13 (1991); Merton H. Miller, The Wealth Transfers of Bankruptcy: Some Illustrative Examples, 41 L. & CONTEM. PROB. 39 (1977).

<sup>4.</sup> See discussion infra Part IV.A.

<sup>5.</sup> This Note is primarily concerned with the efficiency of deviating from the contractual entitlements of banks and the holders of debt securities. Both of these sets of sophisticated economic actors, we can assume, are able to offset the likelihood of bankruptcy in the form of higher interest rates and so forth. Accordingly, concerns of equity are inapposite for these creditors. It is equally safe to assume, however, that less sophisticated trade creditors, as well as involuntary creditors such as tort victims, have not taken such remedial measures, and serious concerns about the equity and fairness of deviating from absolute priority remain. Such considerations, though certainly relevant to any policy debate on the topic of Chapter 11, are not the concern of this Note.

# III. AGENCY COSTS OF DEBT IN THE CONTEXT OF AN INSOLVENT FIRM

Agency costs are the incremental costs of having an agent make claims for a principal. It is generally impossible for a principal to ensure at zero cost that an agent will make optimal decisions from the principal's viewpoint. Adam Smith coined the expression that is now part of our common understanding of the agency cost problem: in the end, agents are dealing with "other people's money," and principals must incur costs in order to ensure their money is put to good use.

The agency problem with respect to debt centers along the perverse incentives management and equity have to make firm decisions that rationally pursue their own interests but detract from the value of the firm and the debt. These problems are most acute (and their concomitant costs the highest) when a firm is highly levered and in the zone of insolvency. For the moment, I will assume an identity of interest between shareholders and management. This assumption is not always safe to make, but it will allow for a more direct illustration of the agency conflict.

<sup>6.</sup> See generally Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

<sup>7.</sup> See id. at 308. In their seminal article, Professors Jensen and Meckling define agency costs as the sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, and (3) the [resultant] "residual loss" (i.e., the loss in welfare due to imperfect monitoring). See also Lemma W. Senbet, Comment, Protecting Stakeholder Interests in Bankruptcy Reorganization, 43 U. TORONTO L. J. 717, 717 (1993) ("The core difficulty in contracting under an agency environment comes from imperfect observability of private actions of corporate insiders, in the form of managerial effort, investment risk choices, and so forth.").

<sup>8.</sup> Adam Smith, The Wealth of Nations 700 (1937).

Management's role in the imposition of agency costs is more complex than some of 9. the literature has recognized. Management's interests are never in perfect harmony with equity's interests, though several important articles seem to assume that management is always shareholder-oriented. See, e.g., Katherine H. Daigle & Michael T. Maloney, Residual Claims in Bankruptcy: An Agency Theory Explanation, 37 J. L. & Econ. 157 (1994); Lucian Ayre Bebchuk & Howard F. Chang, Bargaining and the Division of Value in Corporate Reorganization, 8 J. L. & Econ & Org. 253 (1992). To the contrary, management's interests often shift depending on a confluence of factors. For example, management is often overinvested in the firm due to executive compensation schemes, whereas equityholders are usually fully diversified. See Brian L. Betker, Management's Incentives, Equity's Bargaining Power, and Deviations from Absolute Priority in Chapter 11 Bankruptcies, 68 J. Bus. 161 (1995). The lack of diversification can join management and creditors' interests and cause managers to be more risk averse than owners when the firm is solvent. See Susan Rose-Ackerman, Risk Taking and Ruin: Bankruptcy and Investment Choice, 20 J. Leg. Stud. 277, 291 (1991); Frank H. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. R. 650, 653 (1984). Also, management's human capital is invested entirely in the insolvent firm, and to leave in times of financial distress can be fatal to a CEO's prestige and career prospects. See supra at 278-83. In addition, debtholders may exert a high degree of influence over incumbent management, both as a practical and legal matter. See David A. Skeel, Jr., Creditors' Ball: The "New" New Corporate Governance in Chapter 11, 152 U. PA. L. REV. 917 (2003); Lynn M.

A more crucial assumption—that shareholders are fully diversified and therefore do not bear a substantial risk should a firm liquidate—also underlies this discussion and is safe to assume in the context of large publicly held corporations.

There are several explanations for the existence of debt financing. The trade-off theory of capital structure holds that managers maximize firm value by taking advantage of tax shields. Other theorists posit that managers prefer debt because the expected returns are lower than the returns on equity. Still others emphasize the debt market's role in moni-

LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669 (1993) (suggesting a direct relationship between depth of insolvency and degree of creditor influence over management); Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default, 27 J. FIN. ECON. 355 (1990) (documenting dramatic shift in control over corporate assets and control in favor of large creditors for some firms in financial distress); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 Del. Ch. LEXIS 215, \*108 (Allen, Ch.) (insisting that directors owe a fiduciary duty to the corporate enterprise as a whole, including creditors); In re Xonics, Inc., 99 B.R. 870, 872 (Bankr. N.D. III. 1989) ("When a corporation is insolvent its officers and directors stand in a position of trust not only to the corporation and it shareholders, but also to its creditors."). Keeping these facts in mind, it may be that rational managers care more about the company's survival (and their continued remuneration and reputation) than the dispersion of returns to investors. See Rose-Ackerman, supra, at 278-79; see also James D. Westphal, Board Games: How CEOs Adapt to Increases in Structural Board Independence from Management, 43 Admin. Sci. Q. 511, 518-19 (1998). A final concern merits attention: managers may be deterred from mirroring equity's rational acceptance of risk and return by the possibility of ex post facto shareholder derivative suits against management. See Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996). Despite the degree of complexity, management's interests undeniably move closer to equity's interests as the firm approaches insolvency, for two reasons: first, management compensation is closely tied to the value of equity rather than firm value; and second, much as equity is willing to assume high variance projects with low expected returns to save their investment, a desperate manager will often be willing to do the same to salvage her reputation and job. But see LoPucki & Whitford, supra. at 729 (finding 95% of tainted CEOs either resign or are fired from their positions).

- 10. See RICHARD A. BREALEY & STUART C. MEYERS, PRINCIPLES OF CORPORATE FINANCE 497, 508–10 (2003). The trade-off theory posits that firms choose a debt-equity ratio by maximizing tax savings and minimizing the costs of financial distress, which are discussed infra. Crucial to the trade-off theory is the value of the tax shield that allows corporate taxpayers to deduct payments on corporate debt against corporate income.
- 11. Id. at 511-15; see also Stewart C. Myers, Capital Structure, 15 J. Econ. Persp., Spring 2001, at 81, 91-93. This theory, known as the pecking order theory of capital structure, emphasizes the information asymmetry between investors and managers. Investors, assuming that managers know the company's prospects better than they do, will interpret an equity issue as evidence the stock is overvalued and will discount the share price accordingly. Firms will therefore prefer debt to equity when internal financing is insufficient to fund capital expenditures. The pecking order theory does not explain, however, why alternative financing tactics are not developed to remedy the information asymmetry and obviate the need to discount the stock price for a new equity issue. For example, Myers suggests a "deferred equity" security in the form of a bond that is converted after some period of time—when the information gap has been bridged—into equity securities priced at the original share price but worth the bond

toring management's actions and minimizing free cash flow that could be squandered on organizationally inefficient investments.<sup>12</sup> Although financial economists are not in agreement as to underlying reasons for firms' issuance of debt, anyone minimally acquainted with the financial world knows one thing: corporations issue debt all the time, and too much of it can be a bad thing, due to financial distress costs.<sup>13</sup>

## A. Asset Substitution<sup>14</sup> Problem

Since equity enjoys limited liability for its investment, it stands to lose nothing more than its original capital contribution. As a firm becomes more highly levered with debt, a greater share of corporate earnings must be diverted to service the corporate debt obligations. In such a scenario, the shareholders will prefer higher risk projects than would the same shareholders in a less levered firm in order to increase their own expected return. Rather than engaging a project that will earn just enough to pay back the debt, the shareholders would prefer to gamble a bit and hopefully have some cash left for dividends or reinvestment after paying the debtholders their obligations.

When a firm is insolvent,<sup>15</sup> the shareholders have literally nothing (left) to lose. If an insolvent firm is liquidated, there is usually not enough value to fully satisfy the creditors' claims; the shareholders, as residual claimants, have no legal rights or entitlements to any of the firm's assets. As a result, there exists a negative correlation between the amount of debt issued and the amount of downside risk shouldered by equity.

price. Thus, the investor protects herself from downside risk: if the share price decreases dramatically, the equity investor will obtain more shares but the same value. See id. at 95.

- 13. See infra Part III.B.
- 14. The phrase "asset substitution" owes its provenance to an important article by Clifford W. Smith & Jerold B. Warner, *On Financial Contracting*, 7 J. Fin. Econ. 117, 118–19 (1979).
- 15. Insolvency is not a neatly defined description of a firm's finances. Bankruptcy courts will utilize two alternative formulations in gauging whether a firm is insolvent. The first is called the "balance sheet" test and the second is called the "cash flow" or "equity" test. The "balance sheet" test utilizes a simple ratio of liabilities to the fair market value of the firm's assets. Under the Bankruptcy Code, insolvency is defined as the sum of the debtor's liabilities exceeding the sum of its assets "at a fair valuation." 11 U.S.C.A § 101(32) (2004). The "cash flow" test focuses on a firm's ability to produce sufficient cash flows to pay off debts as they come due. See generally Richard M. Cieri & Michael J. Riela, Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions, 2 DePaul Bus. & Comm. L.J. 295, 306–11 (2004).

<sup>12.</sup> See, e.g., Easterbrook, supra note 9. Judge Easterbrook elaborates the disciplining role of debt. By forcing managers to make regular payments to service a company's debt, management has less free cash flow to squander. In this way, debt serves to minimize the agency conflict between management and equity. Diversified shareholders cannot possibly monitor what their managers do with company cash flows, so they require the firm to take on debt in order to minimize the temptation for managers to expropriate firm cash flows.

Some commentators have likened equity to a holder of a call option on the firm's assets. The shareholders, in effect, sell an unlevered firm to the debtholders in exchange for (1) proceeds from the loan to finance operations, (2) a management contract, and (3) an option to repurchase the firm by paying the principal of the loan plus interest should the investment succeed. As with any option, its value to the option holder increases with the volatility of the underlying asset. Equity, qua option holder, possesses a diminished investment value and little risk during insolvency, and it will prefer to engage in high risk, high variance projects even if those projects carry lower expected returns. If the project fails, equity is in the same state as it was ex ante (that is, zero distribution); conversely, if the project succeeds, equity pockets any value above and beyond that to which bondholders are contractually entitled. Debtholders, by contrast, stand to bear all declines in the residual value of the firm.

As an illustration, imagine a firm with assets valued at \$1 million. The firm owes \$1.2 million to creditors and is experiencing difficulty meeting its obligations due to insufficient cash flows. The firm has a capital structure made up of only debt and equity, and the entire amount of the debt is due at a specified time in the near future. The firm is, by any standard, insolvent. Imagine further that management is entrenched and still reflects the interests of shareholders, whose equity interest is worthless at the moment. Assume further that the firm can invest in two mutually exclusive projects, Project 1 and Project 2. Project 1 requires an initial investment of \$100,000 and will pay out at the end of the year \$70,000 half the time and \$180,000 half the time. The present value of Project 1's returns, assuming a discount rate of 10 percent, is \$114,000 and therefore increases the firm's value by \$14,000. Project 2 also requires an initial investment of \$100,000 and will pay out at the end of the year \$1 90 percent of the time and \$500,000 10 percent of the time. Project 2's net present value is -\$55,000 and therefore decreases firm value by that amount.

From the firm's standpoint, Project 1 is clearly preferable to Project 2. From the shareholders' perspective, the opposite is true. In this stylized example of two mutually exclusive projects, the interests of the firm and the firm's shareholders are in perfect antinomy. The shareholders in this example do not have static interests and incentives. Their investment

<sup>16.</sup> For a discussion of the legal consequences of the interesting intersection of option theory and fiduciary duties, see Geyer v. Ingersoll Publications Co., 621 A.2d 784 (1992).

<sup>17.</sup> See Ronald J. Gilson & Bernard S. Black, (Some Of) The Fundamentals of Finance and Investment 245 (1993).

<sup>18.</sup> John C. Hull, Options, Futures, and Other Derivatives 168 (2003); Brealey & Meyers, *supra* note 10, at 581–82.

risk preferences increase dramatically as the firm is levered up. In such a world, the shareholders will eschew Project 1 and pursue Project 2, despite its dramatic negative net present value and high variance.<sup>19</sup>

Professor John Coffee is correct to analogize equity's interest in an insolvent firm to a controlling interest in a firm whose board of directors is beholden to a constituency of warrantholders. Management would, in such a scenario, be pressured to pursue excessively risky investments. When management and shareholders engage in these asset substitution games, wealth is expropriated from the bondholders to the shareholders and management. Such is the unenviable position of debtholders (and preferred shareholders) when a firm owing obligations approaches insolvency.

### B. Other Agency Costs of Debt

Asset substitution is not the only cause for worry for creditors. For example, managers have other incentives to delay liquidation even if an immediate liquidation would capture more value for creditors. The ability to delay liquidation is related to the asset substitution games discussed *supra*, but it has an additional component. By avoiding an efficient liquidation, management and shareholders can attempt to "wait out" the financial distress storm in hope of a favorable resolution of macroeconomic conditions.<sup>21</sup> Thus, management may seek to hold off liquidation in the hope that random shocks may increase the firm's value, thereby giving them once again a stake in the enterprise.

A recent example is illustrative of these conflicts. In March 2005, Jetsgo, Inc.—the third largest Canadian airline with a majority owner serving as president—filed for bankruptcy protection in Canada. In the eight months preceding the filing, Jetsgo had lost \$88 million, and \$22 million had been lost during the two months preceding the filing. The airline has adopted a strategy that (amazingly) involved pricing fares consistently below its costs of operation. As the airline continued losing money, it began to take on even riskier projects in the mad dash for market share: Jetsgo offered return segments for already heavily discounted flights for a paltry \$1 Canadian. Predictably, the losses accelerated, and the company is now likely to be liquidated. See Jetsgo Lost \$55 Million in 8 Months, Court Told, CBC News, Mar. 11, 2005, available at http://www.cbc.ca/ story/canada/national/2005/03/11/jetsgo-lapierre050311.html (last visited Mar. 13, 2005); Jetsgo Passengers Grounded, at http://gocanada.about.ca/cs/ airlines1/a/jetsgoloonie.htm (last visited Mar. 13, 2005). A less current, but more colorful example, is recounted in In re Tri-State Paving, Inc., 32 B.R. 2 (Bankr. W.D. Pa. 1982). In that case, two individuals who were the sole officers, stockholders, and directors of an insolvent firm withdrew all the contents of the corporation's only bank account and gambled the money away during a trip to Las Vegas. The directors made the withdrawals "for the sole and only purpose of financing a money-spending spree and gambling adventure of the officers . . . which they must not be permitted to do at the risk of the creditors in this proceeding."

<sup>20.</sup> See John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, in Knights, Raiders, and Targets: The Impact of the Hostile Takeover 77, 103–04 (John C. Coffee et al. eds., 1988).

<sup>21.</sup> See Bebchuk & Chang, supra note 9, at 255; GILSON & BLACK, supra note 17, at 248.

The longer a firm delays its entrance into a Chapter 7 proceeding, the more value will be siphoned off in the form of "financial distress costs." Financial distress costs are typically divided into two categories: direct and indirect costs. Direct costs include the administrative and legal expenses of bankruptcy. In the United States especially, firms can remain in bankruptcy for long periods of time without ever facing a real prospect of liquidation.<sup>22</sup> In these cases, fees and expenses do not substantially decrease the value of the estate, but they are still noteworthy, with some studies estimating direct bankruptcy costs as high as 7.5 percent of total book value of assets.<sup>23</sup>

The *indirect* costs of financial distress are comparatively much more injurious to overall corporate value. Indirect costs include trade creditors' unwillingness to continue doing business with the debtor, difficulties in maintaining relationships with suppliers, staff attrition, diverted focus from competitiveness to bankruptcy, customer worries about warranties and lost sales, and an increased cost of capital.<sup>24</sup> Indirect costs are impossible to quantify precisely, but they are more significant than the direct costs.<sup>25</sup> The costs of financial distress (unlike the distributive effects of asset substitution games) represent a loss to *all* corporate stakeholders, and the longer a firm incurs the costs, the more inefficient the bankruptcy is and the less value is available for stakeholders in the end.<sup>26</sup>

<sup>22.</sup> See Lynn M. LoPucki, The Trouble with Chapter 11, 1993 Wisc. L. Rev. 729, 739-45.

See Edward I. Altman, A Further Empirical Investigation of the Bankruptcy Cost Question, 39 J. Fin. 1067 (1984). Recent studies have produced much lower figures than the Altman study suggests. See, e.g., Lynn M. LoPucki & Joseph W. Doherty, The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases, 1 J. Emp. Leg. Stud. 111 (2004) (estimating that professional fees amounted to 1.4% of the distressed debtor's total assets at the beginning of the bankruptcy filing); 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) (estimating the figure at 1.8% of prepetition asset value); Brian L. Betker, The Administrative Costs of Debt Restructuring: Some Recent Evidence, 26 Fin. Mgmt. 56 (1997) (finding a ratio of direct costs to assets of 3.9% in 75 Chapter 11 cases). The larger the corporate bankrupt, the smaller the percentage of value that is eaten up by legal and administrative expenses. See Barry E. Adler, Bankruptcy and Risk Allocation, 77 CORNELL L. Rev. 439, 465 n.107 (1992). For a current example of a costly bankruptcy, see Marilyn Adams, Bankruptcy Lawyers, Advisers, Land Hefty Airline Deals, USA TODAY, Sep. 26, 2005, available at http://news.yahoo.com/news?tmpl=story&u=/usatoday/20050926/bs\_ usatoday/bankruptcylawyersadviserslandheftyairlinedeals (last visited Sep. 29, 2005).

<sup>24.</sup> See Brealey & Meyers, supra note 10, at 501-02; see also Lawrence A. Weiss, Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims, 27 J. Fin. Econ. 285 (1990).

<sup>25.</sup> See Lucian Arye Bebchuk & Jesse M. Fried, A New Approach to Valuing Secured Claims in Bankruptcy, 114 HARV. L. REV. 2386, 2406 (2001).

<sup>26.</sup> See Frank J, Fabozzi et al., Recent Evidence in the Distribution Patterns in Chapter 11 Reorganizations, 2 J. FIXED INCOME 6 (1993).

Other opportunities for abuse exist. Shareholders will likely pressure management to "cash in and run" by declaring dividends before the firm enters into bankruptcy protection.<sup>27</sup> When shareholders capture this value on the eve of bankruptcy, debtholders lose as the decrease in firm value (due to the cash dividend) is shared among debtholders. Another problem plays out in reverse: when a highly levered firm needs additional capital to pursue positive NPV projects, equity will be unwilling to contribute additional equity capital because, in effect, the increase in firm value is shared with the creditors.<sup>28</sup> A final difficulty is the "bait and switch," or claim dilution, problem. If a moderately or barely levered firm suddenly announces its intention to lever up significantly, all the firm's debt becomes riskier, including the former low risk debt. By rendering this formerly safe debt risky, the shareholders can impose a capital loss on the old debtholders and obtain an identical increase in the value of equity.<sup>29</sup>

### C. Agency Costs Ultimately Borne By Shareholders

Of course, any agency costs imposed on creditors to monitor and curtail shareholder malfeasance will ultimately be borne by the shareholders themselves. Creditors will contract with the borrowing corporation ex ante through such devices as bond indentures and loan agreements containing covenants. These and other contractual arrangements aim to restrict the abilities for management and shareholders to shift uncompensated risk onto the creditors. Negotiating the covenants,

<sup>27.</sup> See Brealey & Meyers, supra note 10, at 505.

Of course, the law, both bankruptcy and non-bankruptcy, has developed ways to discourage these courses of action that harm overall firm value. See, e.g., DEL. CODE ANN., Tit. 8 § 170(a) (providing that dividends must be paid either from a firm's surplus or out of the corporation's net profits for the fiscal year in which the dividend is declared and/or the preceding year); Del. Code Ann., Tit. 8 § 174(a) (2003) (making directors liable to the corporation, or "to its creditors in the event of dissolution or insolvency," for willful or negligent violation of the state's statutes regarding the payment of dividends); 11 U.S.C. § 548 (permitting the bankruptcy trustee or debtor in possession to avoid fraudulent transfers, which can include excessive dividend payments). See, e.g., Pereira v. Equitable Life Ins. Soc'y of the United States (In re Trace Int'l Holdings, Inc.), 289 B.R. 548, 557 (Bankr. S.D.N.Y. 2003) (holding that an insolvent Delaware corporation cannot lawfully pay a dividend to shareholders and that the trustee is able to recover the payment under § 548). For a related case, consider In re Image Worldwide, Ltd., 139 F.3d 574 (7th Cir. 1998), where a debtor guaranteed loans of an affiliated corporation on the eve of bankruptcy and paid the loans despite creditors' objections. The court upheld the bankruptcy judge's determination that the transfer (i.e., the guarantee) was not for "reasonably equivalent value" and was recoverable for the benefit of the estate. Note, however, that fraudulent transfer and preference payments are voidable at the discretion of the party in control of the estate. Creditors do not have the authority to challenge these payments ex post. Since most firms in Chapter 11 are guided by old management as a debtorin-possession (see discussion Part IV.B.1 infra), the agency conflicts may remain.

<sup>29.</sup> See Brealey & Meyers, supra note 10, at 505-06.

and monitoring ratios and "event risks" is expensive, and shareholders can be sure to pay for these safeguards in the form of higher interest rates.<sup>30</sup>

Much progress has been made in the drafting of bond covenants, and much of that progress is due to insights about the options implicit in the debt contract. Lenders, however, do not have limitless resources (or imagination) to anticipate every possible manifestation of share-holder/management malfeasance. Additionally, some of the conflicts that result in agency costs, most notably the asset substitution problem, are difficult to contract around. This difficulty is exacerbated if, as in the United States, the bankruptcy laws allow management to remain in charge of a bankrupt corporation under the bankruptcy courts' jurisdiction.<sup>31</sup>

## IV. Does Deviating from Absolute Priority Temper Agency Conflicts in the Context of Chapter 11 Reorganizations?

## A. Empirical Observations

Empirical investigations confirm what bankruptcy lawyers know through practice: bankruptcy courts<sup>32</sup> routinely approve Chapter 11 reorganization plans that deviate from absolute priority, usually in favor of shareholders.<sup>33</sup> According to one study, shareholders receive, on average, 7.6 percent of total corporate value *in excess of their contractual legal* 

<sup>30.</sup> See id. at 507.

<sup>31.</sup> The U.S. Bankruptcy Code allows for management to remain at the helm of a filing company that is a "debtor-in-possession." See 11 U.S.C. § 1101(1) (2005). As a practical matter, management stays on (at least at first) in almost all cases and the appointment of a trustee or examiner is reserved only for cases of extreme abuse. See, e.g., In re Microwave Prods. of Am. Inc., 102 B.R. 666, 670 (Bankr. W.D. Tenn. 1989) ("The appointment of a trustee is the exception rather than the rule in chapter 11 cases, and is an extraordinary remedy available to creditors."). See also discussion infra Part IV.B.1.

<sup>32.</sup> The courts' (and the Code's) willingness to accommodate such plans affects negotiation in and out of Chapter 11. Thus, equity manages to extract value in informal workout negotiations and pre-packaged bankruptcies ("pre-packs") as well. For a theoretical analysis of how the availability of Chapter 11 shapes workout and pre-pack negotiations, see Eli Berkovitch & Ronen Israel, The Bankruptcy Decision and Debt Contract Renegotiations, 2 Eur. Fin. Rev. 1 (1998). Some have found results consistent with lower (but still substantial) bargaining leverage for management and equity in pre-packs and workouts than in full-blown Chapter 11 proceedings. See Maria Carapeto, Is Bargaining in Chapter 11 Costly? (unpublished manuscript) (Oct. 6, 2003), available at http://www.cass.city.ac.uk/faculty/mcarapeto/papers/Bargaining.pdf (last visited Mar. 13, 2004).

<sup>33.</sup> In addition to the articles discussed in the text, readers should consult Julian R. Franks & Walter N. Torous, A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations, 35 J. Fin. Econ. 349 (1994) and Carapeto, supra note 32.

entitlements.<sup>34</sup> Another study—conducted by Professors LoPucki and Whitford—confirmed that in 21 of the 30 largest bankruptcies of *insolvent* companies in the 1980s, equity received some payout in Chapter 11, rarely (though occasionally) amounting to 10 percent of the available assets.<sup>35</sup> Professor Michelle White found that equity receives at least 5 percent of the value of all creditors' claims in all bankruptcy reorganizations, with that proportion increasing as the return to creditors increases.<sup>36</sup> Still another study found 20 of 26 large bankruptcies deviating from absolute priority in favor of equity, and against unsecured creditors.<sup>37</sup> Whereas in relative terms, the divergences from APR are small, the amounts of money at stake are substantial, reaching \$63 million in one case.<sup>38</sup> In almost all the cases examined by Professors LoPucki and Whitford, these costs exceeded the direct costs of bankruptcy.<sup>39</sup>

A study by Professor Brian Betker examining a sample of 75 firms filing for Chapter 11 protection between 1982 and 1990 yields the most conservative estimate of absolute priority deviations. Betker's results demonstrate a 2.86 percent mean deviation from contractual entitlements under the absolute priority rule. The absolute mean deviation is \$5.64 million. The deviations in the Betker study, while less radical than some of the other numbers, are still substantial. Regarding the methodology, Betker calculated the payments to new bank debt at face value where market value was not unascertainable, which in part explains the relatively inflated estimates of firm value that negatively affect the deviation figures. Betker finds a negative correlation between APR deviation in favor of equity and the degree of a firm's insolvency. He also observes a decrease in equity's share as the proportion of claims held by secured

<sup>34.</sup> Allen C. Eberhart et al., Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings, 45 J. Fin. 1457 (1990).

<sup>35.</sup> See Lynn M. LoPucki & William C. Whitford, Bargaining Over Equity's Share in the Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. Rev. 125, 143 (1990) (finding a range in payout from \$400,000 to \$63 million).

<sup>36.</sup> Professor White finds, however, that equity's share increases at a slower rate than creditor's recovery. See Michelle J. White, Survey Evidence on Business Bankruptcy, in Corporate Bankruptcy: Economic and Legal Perspectives 298, 305–06 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

<sup>37.</sup> See Fabozzi, supra note 26.

<sup>38.</sup> LoPucki & Whitford, *supra* note 35, at 142 (charting the recovery for equity in the Wickes, Inc. bankruptcy).

<sup>39.</sup> *Id.* at 178–79.

<sup>40.</sup> Betker, supra note 9.

<sup>41.</sup> *Id.* at 165.

<sup>42.</sup> Id

<sup>43.</sup> Indeed, the face value of the new debt is a bulky slice of the corporate pie in Betker's article, representing, on average, 34.5% of the value of new securities issued by a firm exiting Chapter 11. See id. at 164 n.3.

creditors and large financial institutions increases, suggesting that sophisticated lenders possess leverage in negotiating with management and equity.<sup>44</sup>

#### **B.** Doctrinal Considerations

Numerous provisions in the U.S. Bankruptcy Code (the Code) operate to equity's (and management's) advantage and "stack the deck" against debtholders and other creditors in the plan negotiations. In many of its provisions, Chapter 11 protects management and leaves intact the agency problems discussed supra. Essentially, the Code constitutes a set of mandatory contractual terms for debt contracts in cases of financial distress where firms declare for Chapter 11. Voluntary filings by management commence the vast majority of bankruptcy cases in the United States; 45 therefore, management usually controls these contractual terms and whether they will be imposed on creditors.46 The net effect of the pro-equity elements of U.S. bankruptcy law is to allow equity and management to engage in opportunistic behavior by shifting uncompensated risk and costs onto creditors in the hope of extracting concessions from creditors during plan negotiations. The putative justifications for such a system will be examined later, but this Part aims only to elucidate some of the structures of the Code that operate to the clear advantage of equity and management.

## 1. The Debtor in Possession and the Difficulty of Appointing a Trustee

First, under section 1104(a), the trustee appointment provision, management usually remains in charge of a Chapter 11 firm as a "debtor-in-possession" or DIP. Management, acting as DIP, remains in control of the assets of the bankrupt firm unless the bankruptcy court determines appointment of a trustee is appropriate. A bankruptcy court

<sup>44.</sup> *Id.* at 166-67, 177, 181-82.

<sup>45.</sup> ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXTS CASES AND PROBLEMS 476 (2001) (noting *inter alia* that the Administrative Office of the U.S. Courts ceased to report the relative proportion of voluntary and involuntary petitions in the mid-1980s because involuntary petitions were so rare).

<sup>46.</sup> For a discussion of mandatory contract rules in the context of Chapter 11, see Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Insolvency*, 71 Texas L. Rev. 51, 61–64 (1992). The mandatory contract rule could also be thought of as an option exercisable at the sole discretion of management. In this vein, the mandatory contract rules can be compared to a large amount of warrants outstanding, or even a poison pill. Management can threaten to dilute the creditors' share of corporate value by exercising its right to file for Chapter 11 and run up costs on the creditors.

<sup>47.</sup> See 11 U.S.C. § 1104(a)(1) (2005).

<sup>48.</sup> See 11 U.S.C. § 1104(a)(1)–(2) (2005).

may, upon request, order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management ... or ... if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate." The first clause of the trustee appointment provision has, not surprisingly, received far more attention in the case reports. By flagging certain recognizable legal causes of action, the Code focuses the court's inquiry on the familiar territory of legal—and not economic—concepts. The difficulty of applying legalistic structures to the agency conflict is that judges are handcuffed by burdens of proof, fact sensitive determinations, unavailability of evidence, and generally stringent substantive requirements. Moreover, the qualification of "gross" mismanagement in the list of causes implies that courts and creditors must tolerate a degree of (not quite gross) mismanagement.

The second prong of Section 1104(a)—the "best interests" test—may seem at first blush more amenable to creditors seeking to remove incumbent management. A close reading, however, reveals that appointing a trustee under the best interest test requires that the appointment be in the favor of nearly *all* corporate constituencies.<sup>52</sup> When management is going to bat for equityholders, it is implausible (and, to bring the discussion from theory to practice, vanishingly rare) that a court would appoint a trustee over equity's objection under the "best interests" test.<sup>53</sup>

The practical consequence of the stringent requirements for trustee appointment is a strong presumption in favor of management's continued control over corporate assets and decisionmaking. Courts have held that trustee appointment is an extraordinary remedy,<sup>54</sup> and empirical studies predictably reveal the rareness with which such appointments occur.<sup>55</sup>

<sup>49.</sup> Id.

<sup>50.</sup> The games management play with an insolvent firm do not approach the level of fraudulent misconduct. Though asset substitution games, like fraud, have undeniable allocative effects, those effects are not in any sense legally culpable on any fraud theory. As long as managers refrain from self-dealing and outright fraud, trustee appointment is unlikely.

<sup>51.</sup> COLLIER ON BANKR. (Lawrence P. King ed., 2002).

<sup>52.</sup> The "and" in the clause makes the language conjunctive and requires that creditors, equity, and "other interests" agree that the trustee would benefit their individual interests. See 11 U.S.C. § 1104(a)(2).

<sup>53.</sup> But see In re Marvel Entertainment Group, Inc., 140 F.3d 463, 474–75 (3d Cir. 1998); see also In re U.S. Mineral Products, Co., 2004 WL 1758499, at \*2 (3d Cir. 2004) (affirming bankruptcy court's authority to order trustee appointment sua sponte and citing 11 U.S.C. §105 for the proposition that failure of a party in interest to move for trustee appointment will not preclude action by the court).

<sup>54.</sup> See, e.g., In re Sovereign Estates, Ltd., 104 B.R. 702 (Bankr. E.D. Pa. 1989); In re William A. Smith Constr. Co., Inc., 77 B.R. 124 (Bankr. N.D. Ohio 1987).

<sup>55.</sup> See LoPucki & Whitford, supra note 9, at 699 (explaining study in which only 2 out of 43—or 5%—large Chapter 11 cases appointed trustees).

## 2. The DIP's Exclusive Right to Propose Plan of Reorganization

In addition, the DIP possesses a 120-day window of exclusivity to propose a plan. This period of exclusivity extends to 180 days if the DIP exercises its exclusive proposal right within the first 120 days. Therefore, creditors must either wait out the 180 days (and likely watch corporate value melt away like an "ice-cream pie" or show themselves to be willing to put retained equity securities on the bargaining table. The situation is most dire for holders of unsecured debt securities. For these investors, the DIP can postpone interest payments on the claim until a reorganization plan is approved. Since managers know creditors want a quick resolution of the reorganization proceedings, they may threaten unfavorable terms to some debt claimholders if those claimholders do not agree to concessions and impairment of their rights under the APR.

## 3. Continued Control over Operation and Business Decisions

Perhaps management's most powerful weapon to wield on equity's behalf is operational decision-making authority. Managers, acting as the DIP, retain their authority to bind the company to a course of action or investment, provided such transactions are conducted "in the ordinary course of business." If a creditor or (in the case management is creditor-friendly) a shareholder objects as to the appropriateness of the transaction and the transaction is out of the "ordinary course of business," that objecting party has the right to "notice and a hearing."

Current doctrine prescribes a bipartite test, consisting of "horizontal" and "vertical" components, to determine the ordinariness of a business transaction. The "horizontal" test determines whether the contemplated transaction is of the sort commonly undertaken by firms in the debtor's industry. The "vertical" dimension is more interesting for our purposes, as it highlights the risk and return interplay that forms the basis of the

<sup>56.</sup> See 11 U.S.C. § 1121(b) (2005).

<sup>57. 11</sup> U.S.C. § 1121(c) (2005).

<sup>58.</sup> AVINASH K. DIXIT & BARRY J. NALEBUFF, THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE 45, 286 (1991) (analogizing the bargaining process to a group of children positioning to secure for themselves the largest piece of a steadily melting ice-cream pie).

<sup>59. &</sup>quot;Claim" is used instead of "debt" or "amount owed" because creditors are vested with a bankruptcy "claim" to the estate's assets upon filing a "proof of claim." See 11 U.S.C. § 502(a) (West 2005). A "claim" is defined as "a right to payment, whether or not such right is reduced to judgment . . . secured, or unsecured." 11 U.S.C.A. § 101(5) (West 2005).

<sup>60.</sup> For unsecured creditors, the claim amount is capped at the amount owed and may never include "unmatured interest." 11 U.S.C. § 502(b)(2) (2005).

<sup>61. 11</sup> U.S.C. § 363(c) (2005b).

<sup>62.</sup> Id.

agency conflicts. According to the "vertical" test, a court, in determining whether a creditor is entitled to "notice and a hearing," will consider whether the transaction subjects the creditor to more risk than the risk they accepted *ex ante* and could reasonably expect when they extended credit. If a creditor moves for a hearing under section 363(b), and the court determines that the transaction would transfer risk onto the creditor for which the creditor is not compensated, then the bankruptcy court will grant a hearing to allow the creditor to argue its case. Note also that section 363(b) does not prescribe that a judge must enjoin the "unordinary" transaction; it merely grants an injured creditor the right to voice its concerns in a hearing. Hearings are expensive and unpredictable. Creditors will usually forego a section 363(b) hearing and avoid the costs. Again, the presumption in favor of debtor control of assets reduces creditors' leverage in Chapter 11 negotiations.

Though other parties may certainly propose business suggestions, only the DIP has the authority to bind the debtor, and therefore it exercises an ultimate veto on any proposed courses of action. As a general matter, courts have interpreted "the course of business" under section 363(b) broadly and have been reluctant to intrude on management's "business judgment."

## 4. Information Asymmetry and Thorny Valuation Problems

A final matter merits attention: information asymmetry. In Chapter 11, the equity holders, creditors, and other stakeholders are essentially attempting to value the firm through negotiating alternative plans; <sup>65</sup> at the conclusion of the negotiation process, securities will be distributed for the new firm according to the results of the negotiations. The Code dictates the parameters within which the bargaining occurs. The relative

<sup>63.</sup> See In re Roth American, Inc., 975 F.2d 949, 953 (3d Cir. 1992); Burlington Northern R.R. Co. v. Dant & Russell, Inc., (In re Dant & Russell, Inc.) 853 F.2d 700, 705–06 (9th Cir. 1988); Chaney v. Official Comm. of Unsec. Cred. (In re Crystal Apparel, Inc.), 207 B.R. 406, 409 (S.D.N.Y. 1997); Armstrong World Indus., Inc. v. James A. Phillips, Inc., (In re James A. Phillips, Inc.), 29 B.R. 391, 394 (S.D.N.Y. 1983) ("The touchstone of 'ordinariness' is thus the interested parties' reasonable expectations of what transactions the debtor in possession is likely to enter in the course of its business."); Committee Of Asbestos-Related Litigants v. Johns-Manville Corp. (In re Johns-Mansville Corp.), 60 B.R. 612, 616–18 (Bankr. S.D.N.Y. 1986); Indian Motorcycle Assoc., Inc., (In re Drexel Burnham Lambert Group, Inc.), 157 B.R. 532, 537 (S.D.N.Y. 1993); see also Benjamin Weintraub & Alan N. Resnick, The Meaning of "Ordinary Course of Business" Under the Bankruptcy Code—Vertical and Horizontal Analysis, 19 UCC L.J. 364 (1987).

<sup>64.</sup> See Dardarian v. La Sherene, Inc., (In re La Sherene, Inc.), 3 B.R. 169, 174 (N.D. Ga. 1983) (expounding a presumption of ordinariness arising from the belief that current management is best suited to orchestrate a debtor's business rehabilitation).

<sup>65.</sup> See Lucian Ayre Bebchuk, A New Approach to Corporate Reorganizations, 101 HARV. L. REV. 775, 779-80 (1988).

availability of information necessarily affects the negotiating posture of interest holders in a Chapter 11 proceeding, and the effective disclosure of information is pivotal to the negotiation process. Due to the structural information asymmetry inherent in a debtor-controlled estate, creditors can find themselves without the necessary data respecting asset valuation and possible alternative business plans, materially weakening their negotiating position.

Most plans result in unanimous approval by the interest and claims holders, though a "cram down"—in which a plan is approved without unanimous approval—is always available, and its shadow overhangs the bargaining. A plan proponent may cram down a plan only if the proposed plan respects the APR. Even after equity's 180-day exclusivity period expires, equity may—especially if its option is barely out-of-themoney and its request is more likely to elucidate the rights of the parties —request a valuation of the firm, which requires an expensive estimation of future earnings. The mere prospect of such a valuation makes creditors willing to voluntarily impair their legal entitlements to purchase equity's acquiescence.

As a result, plans are usually consensual agreements among the negotiating parties, with one caveat: the information asymmetry cuts decidedly in favor of management. The Code is parsimonious in its efforts to bridge the information gap, requiring only that the DIP provide "adequate information" to each "holder of a claim or interest" before

<sup>66.</sup> See Ryan Operations G.P. v. Santiam-Midwest Lumber Co., 81 F.3d 355, 362 (3d Cir. 1996) ("[The] disclosure requirements are crucial to the effective functioning of the federal bankruptcy system. Because creditors and the bankruptcy court rely heavily on the debtor's disclosure statement in determining whether to approve a proposed reorganization plan, the importance of full and honest disclosure cannot be overstated.").

<sup>67.</sup> *Cf.* Eberhart, *supra* note 34, at 1459.

<sup>68.</sup> The "cram down" requires a yes vote from a double majority (one-half of claimants, representing at least two-thirds the value of the total claims) of each class of creditors.

<sup>69.</sup> See 11 U.S.C.A. § 1129(b)(1)–(2) (West 2005). A plan may be "crammed down the throat" (as the not-too elegant trade metaphor has it) of dissenting creditors provided it is "fair and equitable," which requires that "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property." *Id.* 

<sup>70.</sup> See Betker, supra note 9, at 166-67.

<sup>71.</sup> Of course, this expense (like all administrative expenses) will come out of the creditors' share.

<sup>72. 11</sup> U.S.C.A. § 1125(a)(1) (West 2005) defines adequate information as "information of a kind, and in sufficient detail, as far as is reasonably practicable in the light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interest of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan." (emphasis added). The House Report makes clear that the determination of what constitutes "adequate information" should be made on a "case-by-case" basis. See H.R. Rep. No. 95-595, 226-27 (1977),

that party may vote on any management reorganization plan.<sup>73</sup> The definition of "adequate information" explicitly disavows any requirement for management to discuss other possible plans,<sup>74</sup> and section 1125(b) empowers courts to "approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets."<sup>75</sup> The requirement generally has been interpreted restrictively by courts to include little more than financial statements, which need not meet SEC prospectus standards.<sup>76</sup> Section 1125 preserves the *ex ante* information asymmetry in Chapter 11 and thereby further tilts in equity's favor.

By not mandating a more comprehensive disclosure, the Code alleviates management of the burden of effectuating expensive valuations of assets and in effect establishes a presumption that management's estimates are correct. Faced with two expensive alternatives—forcing a valuation hearing or negotiating based on incomplete informational disclosure—creditors lose out again.

reprinted in 1978 U.S.C.C.A.N. 5963, 6185-86. One court compiled the following nonexhaustive list of 18 factors for evaluating the adequacy of disclosed information under section 1125(b): 1) The circumstances that gave rise to the filing of the bankruptcy petition; 2) A complete description of the available assets and their value; 3) The anticipated future of the debtor, with accompanying financial projections; 4) The source of the information provided in the disclosure statement; 5) The condition and performance of the debtor while in chapter 11; 6) Information regarding claims against the estate, including those allowed, disputed, and estimated; 7) A liquidation analysis setting forth the estimated return that creditors would receive under chapter 7; 8) The accounting and valuation methods used to produce the financial information in the disclosure statement; 9) Information regarding the future management of the debtor, including the amount of compensation to be paid to any insiders, directors, and/or officers of the debtor; 10) A summary of the plan of reorganization; 11) An estimate of all administrative expenses, including attorneys' fees and accountants' fees; 12) The collectibility of any accounts receivable; 13) Any financial information, valuations, or pro forma projections that would be relevant to creditors' determinations of whether to accept or reject the plan; 14) Information relevant to the risks being taken by the creditors and interest holders; 15) The actual or projected value that can be obtained from avoidable transfers; 16) The existence, likelihood, and possible success of non-bankruptcy litigation; 17) The tax consequences of the plan; 18) The relationship of the debtor with affiliates. In re Oxford Homes, Inc., 204 B.R. 264, 269 n.17 (Bankr. D. Me. 1997).

- 73. 11 U.S.C. § 1125(b).
- 74. See supra note 56.
- 75. 11 U.S.C. § 1125(b).
- 76. 11 U.S.C. §1125(d) ("Whether a disclosure statement required under subsection (b) of this section contains adequate information is not governed by any otherwise applicable non-bankruptcy law, rule, or regulation . . . ."); see also In re A.C. Williams Co., 25 B.R. 173 (N.D. Ohio 1982).
- 77. Of course, management's estimates will exhibit systematic optimism. The higher management can value the firm, the more likely equity holders will be entitled to some residual value, which translates to more leverage in negotiations.
- 78. Professor Adler vividly describes Chapter 11's valuation-through-negotiation system as a "war of attrition" in which junior claimants have an unfair advantage. *See* Adler, *supra* note 23, at 447–48.

## 5. A Note on the 2005 U.S. Bankruptcy Reform

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, passed by Congress in April 2005, addresses legislative concerns with putative abuses of the consumer bankruptcy laws. Most of the changes ushered in by the Act relate to consumer bankruptcy procedures, most notably the introduction of a "means test" in Chapter 13 cases. Some provisions of the bill, however, affect business reorganizations under Chapter 11, and the effect of those changes is unclear. Some changes bear mention in the context of this discussion, as they may very well alter the power balance between managers and the firm's security holders.

The most notable change is a restriction in the DIP's ability to petition the bankruptcy court for extensions of the exclusivity period. As amended, section 1121 will now limit the maximum duration of the DIP's exclusivity period to 18 months. Moreover, the 180-day exclusivity period pending consideration of a DIP's proposed plan may not be extended beyond 20 months. Another reform limits the DIP's ability to pay large retention bonuses to key executives. Harvey Miller, the noted bankruptcy expert and investor, sees in the new legislation an example of "creeping repeal" of the current U.S. Chapter 11 framework. Miller and others foresee a shift toward a more creditor-oriented system, but for reasons discussed below, any movement in that direction should be gradual and take into account the important role bankruptcy laws play in affecting managers' pre-filing decision making.

#### C. Normative Implications

The routine deviations from absolute priority in favor of equity and the retention of management have been heartily condemned by financial economists and legal scholars alike. Some argue instead for a market-based, automated insolvency regime. Others advocate a contractualist approach, wherein creditors and debtors are able to choose different con-

<sup>79.</sup> See 11 U.S.C. § 707(b). For a discussion of the policy debates surrounding the "means test," see Law of Debtors and Creditors, supra note 45, at 455–66.

<sup>80. 11</sup> U.S.C. § 1121(d)(2)(A).

<sup>81.</sup> Id. at § 1121(d)(2)(B).

<sup>82.</sup> Id

<sup>83.</sup> Dan Roberts, Bankruptcy Deadline May Focus Minds, FIN. TIMES, Oct. 7, 2005, at 27.

<sup>84.</sup> See, e.g., Miller, supra note 3; Adler, supra note 23; William H. Meckling, Financial Markets, Default, and Bankruptcy: The Role of the State, 41 L. & CONTEM. PROB. 13 (1977).

<sup>85.</sup> See Bebchuk, supra note 65; Mark J. Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 COLUM. L. REV. 527 (1983); Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 YALE L.J. 1043, 1085 (1992); Barry E. Adler, A Theory of Corporate Insolvency, 72 N.Y.U. L. REV. 343 (1997).

tractual arrangements to guide the debtor through reorganization or liquidation should financial distress befall the firm. <sup>86</sup> The contractualists rely on the Coasian notion that with well-defined property rights and without transaction costs, private contract negotiating (and renegotiating) will ensure an *ex post* efficient outcome.

If Chapter 11—with its inefficiencies relating to management control and APR deviations—is to survive these critiques, it is in need of a justification. Some justify retaining and empowering management, despite the attendant agency costs, on the grounds that the efficiency-based critiques are wrong to blithely assume that the costs of financial distress can be efficiently allocated by markets or *ex ante* contracting.<sup>87</sup>

Others emphasize the collective nature of bankruptcy and the desirable goal of providing an efficient method of realizing assets' value and distributing that value to the creditors. These theorists, led by Professor Thomas Jackson, hypothesize a "creditors' bargain" in which creditors agree to tie themselves to the mast of Chapter 11 in order to obviate the need to contract for every contingency. In this view, bankruptcy should respect non-bankruptcy entitlements except to the extent necessary to reduce the collective action problems the system was designed to resolve. Mandated bankruptcy sharing of risks and control is the preferable alternative to (1) a creditors' rush to dismantle the debtor under state law collection procedures or (2) endless proliferation of costly contracts sharing the risks ex ante. Most relevant for the purposes of the current discussion on agency costs, it also provides for a limited interest

<sup>86.</sup> See Rasmussen, supra note 46; Alan Schwartz, Bankruptcy Contracting Reviewed, 109 YALE L.J. 343 (1999).

<sup>87.</sup> Professor Elizabeth Warren is concerned with the reductionism that advocates wholesale repudiation of Chapter 11 because it is perhaps inefficient in achieving one of its many goals. She warns that "changes pursued for one end may simultaneously move the system further away from a number of other objectives." Elizabeth Warren, Bankruptcy Policymaking in an Imperfect World, 92 Mich. L. Rev. 336, 387 (1993) [hereinafter Imperfect World]. Warren also stresses the dearth of reliable empirical data about the operation of incentives at work for competing parties, especially in routine cases. See generally Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775 (1987). Even if lawmakers and scholars could agree on the goals of the system (for Warren, the chief—and sometimes competing—goals include the preservation of value for failing businesses, distributing that value according to efficient and sensible policies, internalizing the costs of business failure, and ensuring that the system provides sufficient incentives for debtors to choose bankruptcy voluntarily thus obviating government monitoring), the best rules through which lawmakers or private contracting parties pursue those goals are by no means obvious. Imperfect World, supra, at 387.

<sup>88.</sup> See THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Thomas H. Jackson & Robert E. Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75 VA. L. REV. 155 (1989); Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 YALE L.J. 857 (1982).

<sup>89.</sup> Note that such "perfect contracting" is impossible. Professors Baird and Rasmussen contend that such contracting is fast becoming the norm. Unfortunately, they do not point out how creditors have managed to contract around agency problems.

for equity by strengthening management's hand in Chapter 11. By allowing the DIP to maintain control of the ship while it navigates choppy waters, the Code grants management an interest in the enterprise and mutes the incentive to gamble or abandon it.<sup>90</sup>

Limiting the enforceability of bargained-for contracts in the bank-ruptcy context (i.e., deviating from the APR in favor of equity) can be seen as a tax on the contracting parties. Debtors have a higher cost of capital because creditors cannot rely on their contractual entitlements in cases of financial distress, and everyone suffers from a dead weight loss of foregone efficient debt contracts. The levying of the tax may be justified, though, if the costs of planning for financial distress ex ante would be even higher. Put another way, it may be ex ante inefficient to write down creditors' claims in favor of shareholders, but it could be ex post efficient, in that it provides managers and equity holders with the right incentives to maximize firm value once in bankruptcy.

There are examples of ex ante efficiency gains too.<sup>94</sup> The most important ex ante efficiency enhancement is the incentive provided by continued debtor control and APR violations for managers to declare bankruptcy in the first place. Management desires to remain in place, and equity wants to encourage management to extract some value on equity's behalf. To the extent distributing value and control to managers and shareholders assuages the pain of bankruptcy, those parties will be less inclined to disguise financial distress costs and more inclined to file for bankruptcy at the right time.<sup>95</sup> Encouraging the optimal timing of a

<sup>90.</sup> See Mark J. Roe, Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics, 75 Va. L. Rev. 219 (1989) (summarizing, but disagreeing with, the Jackson and Scott article); Daigle & Maloney, supra note 9.

<sup>91.</sup> Jackson & Scott, supra note 88, at 202.

<sup>92.</sup> Jackson and Scott write: "We have suggested that the distributional effects of bankruptcy are a bankruptcy tax imposed on the participants in the collective proceeding. To the extent that the tax revenues are used to support the welfare of the claimants as a group, one can visualize the parties agreeing to so burden themselves in an ex ante bargain." *Id.* at 203– 04.

<sup>93.</sup> See David C. Smith & Per Strömberg, Maximizing the Value of Distressed Assets: Bankruptcy Law and the Efficient Reorganization of Firms, in Systematic Financial Distress: Resolution and Containment (Patrick Honohan & Luc Laeven eds., 2003).

<sup>94.</sup> See Clas Wihlborg & Shubhashis Gangopadhyay, Infrastructure Requirements in the Area of Bankruptcy Law (2001) (unpublished working paper, on file with the Wharton School Financial Institutions Center), available at http://fic.wharton.upenn.edu/fic/papers/01/0109.pdf (last visited Apr. 14, 2005).

<sup>95.</sup> The positive ex ante effects should be clear from the above discussion. Professor Bebchuk, however, is right to point out the potential negative effect of attenuating the disciplinary role of debt. See Lucian Ayre Bebchuk, Ex Ante Costs of Violating Absolute Priority in Bankruptcy, 57 J. Fin. 445 (2002). Admittedly, some managers may be tempted to take on risky projects, secure in the knowledge that no one will be completely shut out of the bargaining process if APR is not respected. I presume, however, these inefficient decisions are substantially outweighed by the efficiency benefits resulting from timely filings. Managers are

bankruptcy filing is one of the major justifications of Chapter 11 and one that will be taken up again in the discussion of French bankruptcy to follow. The "bankruptcy tax," in this way, operates as a control on negative externalities relating to management incentives as to filing decisions. Moreover, the tax (like a government tax raised to support a public good, such as national defense) may solve creditors' collective action problem. Encouraging debtors to petition bankruptcy courts at the right time is a crucial element of any insolvency system and one that the French system, as we will see below, addresses inadequately.

Professor Jackson's theory highlights the conflicting goals of bankruptcy. Chapter 11 is imperfect, but it does not follow, as Professor Warren has pointed out, that any attempt to balance the competing values of bankruptcy law is pointless. Though Chapter 11 does preserve many of the agency costs that exist outside of bankruptcy, it also provides efficient solutions to other problems inherent in the insolvency dilemma.

As a final note, a recent series of articles by Professors Rasmussen, Baird, and Skeel challenge the underlying logic of much of the bankruptcy literature of the 1980s and 1990s. According to Baird and Rasmussen, increasingly complex debt contracts that allocate control rights ex ante, a deemphasis of firm-specific specialized assets, and a developed capital market for distressed firms have fundamentally altered the Chapter 11 landscape. The intangible assets in today's economy—because of their increasing liquidity and fungibility—only have value if a company is doing well and are not worth protecting otherwise. In essence, they argue that the idea of going concern is anachronistic. They argue further that bankruptcy theory and practice is returning to Ronald Coase's insight that assets should only be located in a given firm if they are most valuable in that firm. If assets are no longer firm-specific, it

not likely to succumb to equity's pressures to take on risky projects because of management's lack of diversification and its disproportionate concern with the possibility of financial ruin. See Rose-Ackerman, supra note 9. As discussed supra, managers' caution melts away as the heat of financial distress turns up, and incentives to bet the ranch can appear inevitable. See generally sources cited supra note 9.

<sup>96.</sup> See Robert K. Rasmussen & Douglas G. Baird, The End of Bankruptcy, 55 STAN. L. REV. 751 (2002) [hereinafter End]; Robert K. Rasmussen & Douglas G. Baird, Chapter 11 at Twilight, 56 STAN. L. REV. 673 (2004) [hereinafter Twilight]; Skeel, supra note 9.

<sup>97.</sup> The authors believe that sensible allocations of rights are available that ensure "the shutdown decision will reside in the hands of those with the best information and the appropriate incentives to exercise it correctly." End, supra note 96, at 778. This actor is the residual stakeholder (usually the senior lender who will not be compensated in full) who stands to reap the marginal dollar of gain or suffer the marginal dollar of loss from the firm's activities. Id. at 785. Professor LoPucki thinks such a contract is only a theoretical possibility and questions Baird and Rasmussen's confidence that significant progress has been made in this regard. See 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, 662-63 (2004).

<sup>98.</sup> End, supra note 96, at 757-58.

follows that Chapter 11 should not protect them but should instead help transfer them to a different firm. Rasmussen and Baird claim that Chapter 11 now serves primarily as little more than an auction block where buyers purchase control of assets in prearranged deals.<sup>99</sup>

Skeel finds an emerging pro-creditor thrust to Chapter 11 and a movement away from stakeholder negotiations and towards asset sales and claims trading for corporate control. The emergence of DIP financing, Skeel argues, transfers control from management to the postpetition lender. In addition to the new focus on DIP financing, creditors often offer management "pay for performance" bonuses tied to the expeditious resolution of the Chapter 11 proceeding. Recent cases such as World-Com, Enron, Global Crossing, and Adelphia "powerfully reinforce the norm of directorial responsiveness to creditors, and particularly to creditors' calls for [management] to step down."

Both articles highlight a trend away from stakeholder negotiations and towards more creditor control and more liquid distressed debt markets.<sup>104</sup> As time goes on, we can only hope that creditors will invent modes of contracting in such a way to minimize the costs associated with the agency conflict and to expedite the restructuring. A number of problems, however, some empirical and others theoretical, remain unanswered by these recent articles.

First, many of the recent publicized Chapter 11 bankruptcies were steeped in fraud, sometimes at the highest levels of management. In such circumstances, it is hardly surprising that management had little leverage and that creditors largely ran the show. Indeed, Skeel admits that in these bankruptcies, "the creditors' threat to call to appoint a trustee [was] far more potent." Second, no empirical data from recent years suggests a significantly diminished place for equity and management at the negoti-

<sup>99.</sup> According to Baird and Rasmussen, more than half of large, publicly traded firms currently entering Chapter 11 undergo section 363(b) sales that result in a transfer of control of the firm. Twilight, supra note 96, at 675.

<sup>100.</sup> Skeel, supra note 9, at 918-19.

<sup>101.</sup> Id. at 923-26.

<sup>102.</sup> Id. at 926-30.

<sup>103.</sup> Id. at 932.

<sup>104.</sup> For a brief summary of the ascendancy in importance of distressed debt financing in recent years, consult Harvey R. Miller & Shai Y. Waisman, Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. BANKR. L.J. 153, 181–82 (2004); see also Dan Roberts, Floodgates Open To a New Style, Fin. Times, Mar. 11, 2005, at B1. For an interesting recent example, consider the zeal with which hedge funds are currently gobbling up stakes of Delphi Corp., which filed in Chapter 11 on Oct. 8, 2005. See Stephanie Kirchgaessner & Bernard Simon, Hedge Fund Buys 9% Stake in Delphi, Fin. Times, Oct. 11, 2005, at 17.

<sup>105.</sup> Skeel, *supra* note 9, at 932.

ating table. 106 Third, some of the stratagems mentioned by Skeel have the same effects as APR deviations. For example, "pay-for-performance" bonuses are boons to incumbent management who, after guiding the firm into bankruptcy, will now receive compensation for guiding the firm out. These bonuses transfer value to management and decrease, relative to prebankruptcy entitlements, the creditors' return. Also, DIP financing itself is a Code-sanctioned APR violation and would produce many of the same negative reverberations in the debt market as APR deviations in equity's favor do. For purposes of the agency cost discussion, it matters little what form the deviations from absolute priority take; they are all, in some sense, a bankruptcy "tax," and what matters is that value is being transferred in violation of prebankruptcy contractual entitlements in order to more properly realign managerial incentives. One instructive example is Delphi, the auto parts manufacturer, where an estimated \$87 million in new bonuses—as well as 10 percent of equity in the new company—is supposedly on the table for current management. 107 More empirical research is needed before we can hazard that one APR violation is preferable to another.

Large firms are still filing for Chapter 11, and management often remains at the helm. LoPucki's rejoinder to Baird and Rasmussen finds that contrary to the latter's theory, empirical data testify to a robust docket of large Chapter 11 reorganizations. One need only look to the airline industry, which has resisted calls for consolidation and liquidation and maintained separate operations in Chapter 11. Major airline carriers did not file pursuant to a prepackaged change in ownership but acted to protect against creditors, restructure their contracts and leases, and obtain labor concessions—in short, to participate in a traditional Chapter 11 negotiation in order to preserve their valuable network of nationwide routes. Delphi filed for Chapter 11 protection in October 2005, seeking

<sup>106.</sup> See LoPucki, supra note 97, at 646 (pointing out inter alia the empirical deficiency of the Rasmussen/Baird article).

<sup>107.</sup> See John Gapper, The Danger of Rewriting Chapter 11, Fin. Times, Oct. 13, 2005, at 13.

<sup>108.</sup> LoPucki, supra note 97, at 647-48.

<sup>109.</sup> See Caroline Daniel, Chapter 11: A Failsafe For Bad Managers?, Fin. Times, Mar. 11, 2005, at 5 (reporting on U.S. airlines in Chapter 11 as well as the tendency of foreign jurisdictions to move closer to the U.S. Chapter 11 corporate reorganization model).

<sup>110.</sup> On Sep. 14, 2005, both Delta Airlines and Northwest Airlines filed for Chapter 11 protection. Northwest recently has taken advantage of Chapter 11 to cancel some aircraft leases and terminate or phase out relationships with its unprofitable regional partners. See Northwest Cuts Back Service, available at http://biz.yahoo.com/bizj/050926/1169447.html?.v=1 (last visited Sep. 29, 2005). UAL, too, has been operating in Chapter 11 for three years. On April 9, 2005, United petitioned the bankruptcy court for—and received—a 60-day extension of the exclusivity period in order to "enable United to continue its hard work and implement many of its restructuring initiatives." UAL Asks for Delay on Bankruptcy

to renegotiate contracts and labor agreements and to jettison some less profitable divisions.<sup>111</sup> Delphi's bankruptcy is the largest industrial bankruptcy ever filed. Though the airlines have justifiably received the most press attention in recent months, a robust bankruptcy docket can be observed throughout various industries, testifying to the continued importance of Chapter 11 restructuring in the U.S. corporate community.<sup>112</sup>

Because it retains management and fosters private negotiations to determine a firm's future, Chapter 11 is still the most debtor-friendly insolvency regime in the world. It continues to pursue the goal of en-

*Plan*, N.Y. TIMES, Apr. 10, 2005, at 23. The desirability *vel non* of airlines taking advantage of Chapter 11 protection is a hotly debated question and one that is outside the scope of this Note. The frequency of airline bankruptcy, however, does testify to the continuing robustness of Chapter 11 restructurings.

111. See James Mackintosh, Dan Roberts & Bernard Simon, Delphi Chief Warns of Hard Choices Ahead, Fin. Times, Oct. 11, 2005, at 1.

112. Heating Oil Partners, one of the largest distributors of heating oil in the United States, filed for bankruptcy recently, seeking protection from the 2005 spike in fuel costs. Heating Oil Partners LP Files for Bankruptcy-Court Protection, Sep. 26, 2005, available at http://www.canadianbusiness.com/news/article. jsp?content=b092643A#&page=2 (last visisted Sep. 29, 2005). ThermoView, a company that designs, manufactures, markets, and installs replacement windows and doors, filed for Chapter 11 protection to alter its capital structure and plans on continuing operations. Brent Adams, ThermoView Files For Chapter 11 Bankruptcy **BUSINESS FIRST** OF LOUISVILLE, Sep. 26, 2005. http://www.bizjournals.com/louisville/stories/2005/09/26/daily11.html?page=1 (last visited Sep. 29, 2005). As a final example, consider the bicycle manufacturer Huffy, whose Chapter 11 plan was recently approved by a bankruptcy court after a successful restructuring.

113. To illustrate the pro-debtor thrust to Chapter 11 in a slightly different tone, consider the following tale, reproduced by Insol International:

A businessman was in a great deal of trouble. His business was failing, he had put everything he had into the business, he owed everybody—it was so bad he was even contemplating suicide. As a last resort he went to a priest and poured out his story of tears and woe.

When he had finished, the priest said: "Here's what I want you to do: Put a beach chair and your Bible in your car and drive down to the beach. Take the beach chair and the Bible to the water's edge, sit down in the beach chair, and put the Bible in your lap. Open the Bible; the wind will rifle the pages, but finally the open Bible will come to rest on a page. Look down at the page and read the first thing you see. That will be your answer, that will tell you what to do."

A year later the businessman went back to the priest and brought his wife and children with him. The man was in a new custom-tailored suit, his wife in a mink coat, the children shining. The businessman pulled an envelope stuffed with money out of his pocket, gave it to the priest as a donation in thanks for his advice.

The priest recognized the benefactor, and was curious. "You did as I suggested?" he asked.

"Absolutely," replied the businessman.

"You went to the beach?"

"Absolutely."

couraging management to preserve going concern value and to file for bankruptcy at the right time and not  $\grave{a}$  la française, i.e., only when it is too late.

## V. A Comparative Approach: Looking to the French Law Model

Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (hereinafter LLSV) have documented relationships among states' financial laws and their legal origin. In their seminal law and finance article of 1998, these authors created an index to measure the quality of investor protection in various states and then analyzed the index data across states. <sup>114</sup> The study found correlations between, on the one hand, corporate ownership and investor protection and, on the other, the respective origins of the legal system. In particular, the studies found dramatic differences between legal systems which evolved from the French civil law model and the Anglo-American common law model. <sup>115</sup>

Insol International, Directors in the Twilight Zone 423–24 (2001).

114. See La Porta et al., Law and Finance, 106 J. Pol. Econ. 1113 (1998); see also La Porta et al., Corporate Ownership Around the World, 54 J. Fin. 474 (1999).

But see Daniel Berkowitz, Katherine Pistor & Jean-François Richard, Economic Development, Legality, and the Transplant Effect, 47 Eur. Econ. Rev. 165 (2003); Naomi Lamoreaux & Jean-Laurent Rosenthal, Legal Regime and Business's Organizational Choice: A Comparison of France and the United States (Nat'l Bureau of Econ. Research, Working Paper No. 10288, 2004), available at http://papers.ssm.com/sol3/papers.cfm?abstract\_id=499313 (last visited Jan. 16, 2006). Professors Lamoreaux and Rosenthal's findings paint a different picture: namely, that the broad generalization equating French civil law with higher transaction costs is misguided because it fails to account for the actual historical development of French civil law. Their findings suggest to the contrary that French law offered more organizational forms and flexible contract options than Anglo-American law, which was less responsive to the needs of business community. The Anglo-American common law caught up to French civil law in terms of efficient contract law only in the late twentieth century. In the "Transplant Effect" article, Professors Berkowitz, Pistor, and Richard undercut a different contention underlying the LLSV research. Their article claims that the method by which legal systems are "transplanted" into developing states matters more than the provenance of the legal system. For these authors, the process of implementing (or "transplanting") legal rules to govern financial institutions is more determinative of the effectiveness of legal institutions (or "legality") than what the law actually is. See Stanislaw Gelfer, Katharina Pistor & Martin Raiser, Law and Finance in Transition

<sup>&</sup>quot;You sat in the chair with the Bible in your lap?"

<sup>&</sup>quot;Absolutely."

<sup>&</sup>quot;You let the pages rifle until they stopped?"

<sup>&</sup>quot;Absolutely."

<sup>&</sup>quot;And what were the first words you saw?"

<sup>&</sup>quot;Chapter 11."

States whose financial laws derived from French civil law, in general, possessed weaker investor protection and higher transaction costs. This Note takes as a point of departure LLSV's findings of disparities between French and Anglo-American legal systems, and attempts a comparative analysis of French and U.S. reorganization law, as well as the behavioral incentives those laws create. The results of the comparison are consistent with LLSV's finding of a French/Anglo-American disparity and should have important implications for other states whose legal systems derive from the two models. 116

The French model of corporate insolvency, in contrast to Chapter 11, shuts equity and management out entirely from the discussion that will determine a firm's future. From the time a rehabilitation (redressement) proceeding starts, 117 the court (le tribunal de commerce) and the administrator are firmly in the driver's seat and in pursuit primarily of statutory non-efficiency policy goals relating to continued employment. As a result, the violations from absolute priority in favor of equity are accidental, if they occur at all. Creditors take no comfort in equity's disadvantaged position, though, because their position is equally weak with respect to the controlling court. Instead of addressing the agency conflicts, as Chapter 11 does, by allocating control in the reorganization framework itself, French law takes a punitive stance, dealing with agency conflicts through the criminal and civil penalties with less than encouraging success.

In French bankruptcy, the cardinal concerns are the continued existence of the firm<sup>118</sup> and the retention of its employees. Agency concerns

Economies (Eur. Bank for Reconstruction and Dev., Working Paper No. 49, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract\_id=214648 (last visited Jan. 16, 2006). In synthesis, these articles modify the LLSV findings. French law originally was more business-friendly, and the existing correlation between French civil law and relatively high transaction costs and weak investor protections may be more a consequence of the transplant effect than any intrinsic merits of the respective legal systems. Both sets of authors, however, are in agreement that, broadly speaking, comparing legal systems derived from French civil law to legal systems derived from Anglo-American common law can yield useful relationships. This Note aims merely to accentuate the differences in French and U.S. reorganization laws without taking a position on the broader and interesting questions regarding the historical development of law and finance and the actual determinants of legality.

- 116. Looking to the French model is especially useful because of the large number of states whose bankruptcy laws are based, due to colonization or emulation, on the French model. See La Porta et al., supra note 114, at 1117–18; see also Berkowitz et al., supra note 115, at 166–67.
- 117. Under French law, all bankrupts must ask for rehabilitation (*redressement*) proceedings, and a court will determine whether liquidation or rehabilitation is appropriate. *See* discussion *infra* Part V.A.2.
- 118. The survival of the firm (or, in the words of the French laws, "la sauvegarde de l'entreprise") from article L620-1 of the French Code de Commerce is not to be confused with the preservation of going concern value. Firm survival is often collapsed into the second aim of French bankruptcy law: the protection of employment ("le mantien de l'emploi"). See, e.g.,

are subordinated to the greater policy objective of preventing dislocations in the employment market resulting from insolvency. By addressing the insolvency agency problems through a process largely exogenous to the bankruptcy proceedings, the French laws create new opportunities for abuse and may unwittingly subvert their own stated policy objective of retaining employees. Throughout this discussion, recall as counterpoint how Chapter 11 ties the agency solution directly to the bankruptcy negotiations, in the process muting the agency problems and temporarily engaging all stakeholders in the negotiation of the firm's future.

#### A. The Mechanics of French Bankruptcy Law

French bankruptcy law underwent a dramatic overhaul in the mid-1980s.<sup>119</sup> The government fixed the contours of the laws in their present form in 2000, when it promulgated a substantial amendment.<sup>120</sup> Article 1 of the 1985 Law sets the tone of the bankruptcy laws, listing the objectives of French bankruptcy as (1) saving the enterprise, (2) the preservation of jobs, and (3) the payment of creditors' claims.<sup>121</sup> Controlling interpretations of article 1 dictate that the objectives be taken into account in descending order of importance.<sup>122</sup> Serious discussions about reform of the system—and moving it closer to a debtor-centered Chapter 11 model—have been ongoing since 2003, but the new laws have yet to enter into force.<sup>123</sup>

#### 1. Commencing the Case

In France, debtor-initiated filings are mandatory within 15 days of a debtor's inability to pay its debts as they fall due.<sup>124</sup> French law imposes draconian liabilities on managers and directors for, among other failures,

Moquet Borde & Associés, Corporate Insolvency Law in France, in European Corporate Insolvency 113, 164-66 (Harry Rajak et al. eds., 1995).

<sup>119.</sup> Law No. 84-148 of March 1, 1984, effective March 1, 1985; Law Nos. 85-88 and 85-89 of January 25, 1985, effective January 1, 1986, subject to Decree Nos. 85-1388 and 85-1389 of December 27, 1985 [hereinafter the 1985 Law].

<sup>120.</sup> A substantial amendment was introduced in 1994 as well. I will refer to the corpus of French bankruptcy law as the "1985 Law" since that law provided the framework for contemporary French bankruptcy law.

<sup>121. 1985</sup> Law, supra note 119, art. 1.

<sup>122.</sup> Richard L. Koral & Marie-Christine Sordino, New Bankruptcy Reorganization Law in France: Ten. Years Later, 70 Am. BANKR. L.J. 437, 442 (1996).

<sup>123.</sup> See discussion infra Part V.C.

<sup>124. 1985</sup> Law, supra note 119, art. 3. Managers will be subject to sanctions for failure to file. Arnold Gewelbe, France, in Int'l Corporate Insolvency Law 177, 183 (Dennis Campbell ed., 1992). See Judgment of the Cour de Cassation (Commercial Chamber) in Blanchet contre Cosme Rogeau, in Dalloz Affaires No. 42/1996 (Fr.).

shirking this duty to file.<sup>125</sup> The condition of insolvency, known as *cessation de paiements*,<sup>126</sup> is more like the cash-flow test in U.S. law and not a balance sheet insolvency test.<sup>127</sup> Setting the date of *cessation de paiements* will vary case by case and will establish a frontier after which any payments will receive heightened scrutiny and potential judicial invalidation. A court may commence proceedings *sua sponte* as well.<sup>128</sup> Finally, creditors may procure a summons for an insolvent debtor by establishing that the debt is unquestionable, due, enforceable, backed by title, and uncollectible in previous attempts.<sup>129</sup> When the case commences, a debtor

<sup>125.</sup> Directors can incur liability pursuant to over 40 provisions in French law. Some representative examples include the following: "acting for personal gain including a grant of a pay increase when the company was experiencing great difficulty, failure to keep proper accounts including falsifying or destroying accounting records, not announcing the stopping of payments on debts, taking actions or making decisions that only could cause the company's insolvency, and failure to supervise the company's business." Bruce D. Fisher & François Lenglart, Employee Reductions in Force: A Comparative Study of French and U.S. Legal Protections for Employees Downsized Out of Their Jobs: A Suggested Alternative to Workforce Reductions, 26 Loy. L.A. Int'l & Comp. L. Rev. 181, 193–94 (2003). Most importantly, French law allows creditors to collect from the debtor's management in cases of faulty management. See discussion infra Part V.A.4. Indeed, this tradition of directorial liability in France is well-established. The previous bankruptcy laws established a rebuttable presumption that management's malfeasance caused the corporate collapse and that management was liable for the debts. See Gewelbe, supra note 124, at 202.

<sup>&</sup>quot;Cessation de paiements" is defined as "the impossibility of paying debts due from available assets." Hubert Lafont, The French Bankruptcy System, in CORPORATE BANKRUPTCY AND REORGANIZATION PROCEDURES IN OECD AND CENTRAL AND EASTERN EUROPEAN COUNTRIES 15, 17 (OECD 1994). French bankruptcy courts have developed a jurisprudence of just what will constitute cessation de paiements, which gives prospective notice to managers in struggling firms when the game is up. Establishing the date for cessation de paiements is crucial in a French bankruptcy case, since transactions will be examined and can be declared void insofar as they affect the firm. Id. Experiencing cash flow difficulties does not always signal a firm's irreparable insolvency, and French law provides for the appointment of a "mediator" (conciliateur) under the Act of 1 March 1984 (adopted in response to the financial crises of the 1980s and amended by an Act of 10 June 1994) to draft a plan for a firm's return to viability pending acceptance by the firm and its creditors. Jean-Luc Vallens, The Law in France: Main Features, in BANKRUPTCY AND JUDICIAL LIQUIDATION 21, 23 (Council of Europe 1996). Unlike the full-blown bankruptcy proceedings, however, conciliation did not impose an automatic stay, and it therefore did not provide strong incentives on creditor compliance. Lafont, supra, at 19.

<sup>127.</sup> See supra note 15; see also Insol International, supra note 113, at 186. Note that the requirement that all firms voluntarily file within 15 days of cash flow insolvency necessarily means that the scope of the measure is overbroad, and many balance sheet insolvent firms must file for bankruptcy protection. See Sergio Muro, Deciding on an Efficient Involuntary Filing Petition Rule, 31, paper presented March 10, 2005, at the Cornell LL.M. Seminar Series, available at http://lsr.nellco.org/cornell/lps/papers/6/ (last visited April 14, 2005).

<sup>128.</sup> The court may also appoint a judge to gather further information regarding the company before commencement of full-blown proceedings. Such a judge will then prepare a report, and the court will rule on the report after a hearing where the debtor, a workers' representative, and any other party the court deems possesses an interest will attend.

<sup>129.</sup> Lafont, supra note 126, at 17.

must submit its financial statements and other disclosures to the court.<sup>130</sup> The court also imposes a stay on collection efforts.<sup>131</sup>

### 2. The Observation Period and Administrator Appointment

After the court commences the proceedings, a six-month "observation period" ensues. <sup>132</sup> The first order of business is the appointment of an "administrator." An additional six-month extension is permitted in some cases, and the observation period may be terminated at the request of the administrator, the creditors' representative, <sup>134</sup> the public prosecutor, or the debtor, when the court deems the debtor's rehabilitation prospects to be nil.

Unlike with the Chapter 11 trustee, the appointment of an administrator is mandatory, and he or she will guide the debtor through the reorganization process and, as is most often the case, will put it to rest in liquidation. The administrator "is primarily concerned with resolving the economic and employment problems plaguing the enterprise, elaborating a proposed plan, and managing the debtor's enterprise." The court retains authority to extend the scope of an administrator's charge. One duty of an administrator is to prepare a report indicating the origin, importance, and nature of the debtor's financial distress. The report will analyze—or, as the statute's language has it, *observe*—the debtor's prospects for successful rehabilitation. The administrator communicates the report to the creditors' representative, the debtor, and the workers representation committee. The report must contain the administrator's

<sup>130.</sup> Gewelbe, *supra* note 124, at 183.

<sup>131.</sup> Id. at 192.

<sup>132.</sup> There is a simplified procedure for debtors employing less than 50 persons and an annual turnover below a threshold amount.

<sup>133.</sup> In practice, the court will often undertake a viability analysis on its own and appoint an administrator (instead of a liquidator) only if it appears the firm is capable of rehabilitation. See Claude Maxime Weil, Bankruptcy and Judicial Liquidation, in BANKRUPTCY AND JUDICIAL LIQUIDATION 41, 43 (1996) (providing a helpful description of the dramatis personae of a French bankruptcy).

<sup>134.</sup> The creditors' representative is appointed immediately following the commencement of proceedings. Thus, creditors are not participating directly in the rehabilitation or filing motions with the court. The creditors' representative will be appointed from a list of certified liquidators in the region where the proceedings take place. If at any point the court determines rehabilitation is impracticable or the insolvent firm is not meeting its obligations in the rehabilitation phase, the creditors' representative will become the firm's liquidator.

<sup>135.</sup> Gewelbe, *supra* note 124, at 184. The administrators are court-appointed from a nation-wide list of administrators, and are personally liable without limit for any faulty administration of the estate. The administrators are, however, required to maintain civil liability insurance. Lafont, *supra* note 126, at 18.

<sup>136.</sup> Appointed in a manner similar to the selection of the creditors' representative, the workers representation committee reflects the statutory priority accorded to the interests of labor in the French model.

analysis of whether rehabilitation is possible.<sup>137</sup> If the court and the administrator determine rehabilitation is "manifestly impossible," then the proceedings will become a liquidation (*liquidation judiciaire*). If rehabilitation is feasible, the administrator's report will include a proposed plan of rehabilitation (*plan de redressement*).

Thus, French debtors do not file under a chapter as U.S. debtors do. The 1994 amendments made access to the rehabilitation function contingent on a court determination that a debtor's emergence from financial distress is feasible. The standard of proof required to deny access to rehabilitation protection appears high, but in practice the vast majority of firms filing for bankruptcy protection in France finish as collections of liquidated assets; between 90 and 95 percent of French firms filing for redressement are channeled to liquidation proceedings during this preliminary "observation" period. Seventy percent of these liquidations occur immediately. Notably, more than 150,000 salaried positions are lost through liquidation each year. If we assume that the judges are not liquidating companies arbitrarily (and in violation of the 1985 Law's mandate, which instructs courts to avoid liquidation unless rehabilitation

<sup>137.</sup> The law denies access to rehabilitation proceedings when the court determines that the debtor has (1) stopped making payments, (2) all business activities have ceased, and (3) rescue is manifestly impossible. In such circumstances, the firm is pushed along into mandatory liquidation. See Weijing Wu, Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law, 35 VICT. U. OF WELLINGTON L. REV. 239, 261–63 (2004).

Koral & Sordino, supra note 122, at 448. At present, around 40,000 firms are liquidated each year in converted liquidation judiciaire proceedings. Freshfields Bruckhaus Deringer, Reform of French Insolvency Law (June 2004), available at http://www. freshfields.com/practice/finance/publications/pdfs/8779.pdf (last visited March 26, 2005) [hereinafter Freshfields white paper]. Some estimates put the percentage of firms filing for redressement which end up being liquidated as high as 95%. See e.g., Fédération Bancaire Française, Sauvegarde des entreprises: mieux associer les créanciers au redressement des entreprises en difficulté, Nov. 5, 2003, available at http://www.fbf.fr/Web/internet/content presse.nsf/0/7a8e61d51897f3fac1256dea0052c0ab?OpenDocument (last visited March 26, 2005). The article advocates for reversing this trend by encouraging parties to negotiate as soon as possible: "Pour inverser cette tendance et augmenter les chances de sauvegarde de l'entreprise, le constat des pouvoirs publics et des professionnels est le même: il faut organiser le cadre contractuel du dialogue entre les entrepreneurs et leurs créanciers, dès la détection des difficultés." Id. Lower estimates hover around 90%. See Anne Salomon, Les Faillites à l'Américaine Arrivent en France, Le Figaro, Mar. 1, 2005. See also Christine Lebel, L'ÉLABORATION DU PLAN DE CONTINUATION DE L'ENTREPRISE EN REDRESSEMENT JUDI-CIAIRE 218 (2000); SENATOR JEAN-JACQUES HYEST (OFFICE PARLEMENTAIRE D'ÉVALUATION DE LA LÉGISLATION), RAPPORT SUR LA LÉGISLATION APPLICABLE EN MATIÈRE DE PRÉVEN-TION ET DE TRAITEMENT DES DIFFICULTÉS DES ENTREPRISES, at 8, available at http://www.senat.fr/rap/r01-120/r01-1201.pdf (last visited Apr. 30, 2005).

<sup>139.</sup> Id. at 50

<sup>140.</sup> Dominique Perben, 160th Session of the Assemblé Nationale, Mar.1, 2005, available at http://www.assemblee-nationale.fr/12/cri/2004-2005/20050160.asp#P142\_32064 (last visited Apr. 22, 2005).

is "manifestly impossible"<sup>141</sup>), the data imply that most companies ending up in *redressement* proceedings are past the point of no return. Chapter 11 is by no means an astounding success in this regard, but its success rate—particularly in larger cases—is significantly higher than its French counterpart.<sup>142</sup>

Moreover, there may be some benefit to entering Chapter 11 even if liquidation is the end result. If the filing occurred before creditors could rush to dismantle the debtor, or before the management could siphon off firm value for its own benefit, then Chapter 11 succeeded in maximizing creditors' return even despite the liquidation. Because Chapter 11 often leaves management with a small portion of firm value, it incentivizes managers to file for protection even if liquidation is *inevitable*; such an incentive is notably absent from French bankruptcy law.

What follows is a description of the *redressement* procedures. It is necessary to analyze these procedures in light of the reality that successful rehabilitation proceedings are vanishingly rare in France and are the exception to the rule of liquidation. By understanding the structure of the rehabilitation law, we can better comprehend how the regime affects management's *ex ante* incentives and behavior, as well as how those incentives produce so many irremediable bankrupt firms.

## 3. The Execution Period: Approving and Implementing Plan of Rehabilitation

Throughout the bankruptcy, the debtor remains nominally in charge of operational and business affairs. Unlike Chapter 11, though, the debtor has no direction over the plan of rehabilitation, and even with respect to operations, it is subject to the supervision of the administrator. In this strict division of competences, the administrator focuses on the

<sup>141.</sup> See supra note 137.

<sup>142.</sup> In the 1980s successful reorganizations were rare, though not as rare as in France. For every year since 1989, however, the rate of confirmation for Chapter 11 plans has exceeded 25% and now is over 30%. Reauthorization of the U.S. Dept. of Justice: Executive Office for U.S. Attorneys, Civil Division, Environment and Natural Resources Division, Executive Office for U.S. Trustees, and Office of the Solicitor General: Hearing Before the H. Subcomm. on Commercial and Admin. Law of the Comm. Of the Judiciary, 107th Cong. 76 (2001) (statement of Martha Davis, Acting Director, Exec. Office for United States Trustees, U.S. Dept. of Justice). Confirmed plans do not always avoid liquidation because a percentage of approved plans (around 25%) provide for the firm's liquidation. Even after accounting for these Chapter 11 liquidation plans, the comparative success of Chapter 11 is striking. The success rate for larger Chapter 11 plans is higher still. See, e.g., Lynn M. LoPucki & William C. Whitford, Venue Choice and Forum-Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies, 1991 Wisc. L. Rev. 11, 18, 41 n.105 (finding confirmation rates of 89% to 96% for the largest Chapter 11 plans filed between 1979 and 1988).

overarching goals of the bankruptcy regime, 143 and the managers focus on the firm's commercial activities. Although the debtor will retain title to its property, its control over the firm's assets varies, as it is subject to the virtually limitless discretion the court possesses to circumscribe the debtor's control authority. At a minimum, though, the administrator will exercise a supervisory role over the firm's direction. 144

During the execution period, the administrator and the debtor adopt a plan and put into force. Ultimately, a plan needs court approval in order to obtain legal force.<sup>145</sup> The creditors' representative will receive a copy of the administrator's report and will send a copy to each creditor who filed a claim with the court. 146 A creditor who fails to respond to the proposed plan will be deemed to accept it, which (as a practical matter but not as a legal matter) increases the likelihood the court will approve the plan. 147 If the creditors reject the proposal, the court will specify that all debts must be paid in full over a time period specified by the court itself.148 Once the court approves a plan, it appoints an administrator (usually the same administrator who guided the plan's formation) to supervise plan implementation and distribute the amounts due to creditors. 149 The continued operation of the collection stay is contingent on the debtor's compliance with the rehabilitation plan. 150 The court retains jurisdiction to rescind the plan ex officio or on motion from any aggrieved creditor. 151

Notably, courts can and do make plan acceptance subject to the replacement of one or more members of the debtor's management.<sup>152</sup> The court may further require that voting rights appurtenant to shares held by members of management be exercised by a court-appointed attorney.<sup>153</sup> Moreover, in all cases management is estopped from transferring shares in the company.<sup>154</sup> Other cases involve the court ordering management's divestiture at share prices determined by court-appointed appraisers.<sup>155</sup>

<sup>143.</sup> The administrator is, essentially, a functional instrument of the proceedings. The administrator pursues the stated objectives of the French bankruptcy regime: protecting the company and its business activities, protecting employment, and clearing the deficit. *See* Weil, *supra* note 133, at 45.

<sup>144.</sup> See id. at 43; Gewelbe, supra note 124, at 190.

<sup>145.</sup> Id.

<sup>146.</sup> Id.

<sup>147.</sup> Id.

<sup>148.</sup> Id.

<sup>149.</sup> Vallens, supra note 126, at 24.

<sup>150.</sup> Gewelbe, supra note 124, at 190.

<sup>151.</sup> *Id*.

<sup>152.</sup> Id. at 191.

<sup>153.</sup> Id.

<sup>154.</sup> Id.

<sup>155.</sup> Id.

Because European companies, even more than U.S. companies, have overinvested management, <sup>156</sup> such restrictions undoubtedly weigh heavily on the prefiling decisions of French corporate managers. Indeed, because of the common unity of interest between management and equity in French corporate structure, the agency problems of debt are more pronounced than in the U.S. system, where management is usually, *but not always*, aligned with equity.<sup>157</sup>

As for the contents of the plan, the court exercises plenary authority over the rehabilitation, with no substantive requirements beyond court approval. Like Chapter 11, a plan need not respect absolutely creditors' pre-filing entitlements. Any dissenting creditor, however, is entitled to 100 percent fulfillment of its claim, although payment may be extended<sup>158</sup> and post-filing interest stops accruing.<sup>159</sup> So if a creditor voluntarily accepts less than full satisfaction of its claim, the plan may still proceed, provided the other creditors' claims are paid in nominal—and not real—amounts over the course of the plan. Plans may also provide for the sale of assets or for a complete transfer of ownership.<sup>160</sup> Such plans squeeze out the *ex ante* equityholders but retain the firm as a going concern. In the end, the court's yardstick will be whether "the debtor's financial, economic and employment situation [are] worthy of rehabilitation."<sup>161</sup>

A hypothetical plan in which an administrator proposes 50 percent payment to accepting creditors over five years, 100 percent payment to creditors over ten years, and the continued existence of the debtor *qua* employer will almost certainly obtain the court's blessing. Though such a plan may seem perverse to a student or practitioner of Chapter 11, it is the result of a well-defined policy in favor of firm survival and continued employment. What remains to be explained, however, is why so few plans reach completion of the rehabilitation process.

<sup>156.</sup> The separation of ownership and control, for decades the norm in U.S. capitalism and documented by Adolf Berle and Gardiner Means, is still not dominant in many European markets, where majority shareholders often serve as managers of their firms. See, e.g., Rafael La Porta et al., Corporate Ownership Around the World, 54 J. Fin. 471 (1999).

<sup>157.</sup> See supra note 9.

<sup>158.</sup> The 1994 amendments capped the duration of payment plans, but the payments may still be spread out over 10 years time. The first payments must begin no later than one year after plan approval. See 1985 Law, supra note 119, arts. 65, 74.

<sup>159. 1985</sup> Law, supra note 119, art. 55.

<sup>160.</sup> Gewelbe, *supra* note 124, at 196.

<sup>161.</sup> *Id.* Note that the court's willingness to accept a plan will be a function of the proposed plan's relative congruence with the stated goals of the 1985 Law. *See generally* discussion *infra* Part V.A.

<sup>162.</sup> Some have explained the pro-labor bias of the 1985 Law as a social safety net to curb the relatively high unemployment rates in France. See Koral & Sordino, supra note 122, at 444.

### 4. Penalties and Sanctions for Managers and Equityholders

The sanctions and liabilities directors incur for directorial malfeasance are not, strictly speaking, all part of the bankruptcy regime, though many apply especially when a firm is insolvent. <sup>163</sup> The sanctions include criminal, civil, and bankruptcy-related liabilities. These laws are in part remedial, but their primary focus is deterring management behavior deemed to be contrary to the interests of the firm, and they are therefore concerned with an agency problem. <sup>164</sup>

Courts can attach liability to corporate directors and managers of French sociétés à responsabilité limitée or sociétés anonymes for all or part of an insolvent firm's debts. A tribunal may initiate this procedure—known as an action en comblement de passif—when the disposable assets, or actif disponible, are insufficient to cover the firm's debts. The procedure applies not only to de jure members of management but also to shareholders assuming an active role as de facto managers. Courts also have authority to extend bankruptcy proceedings (and court control) to directors' personal assets in appropriate circumstances.

In some situations, civil sanctions may also be appropriate. Personal bankruptcy (faillite personnelle) may be imposed on the management of a corporate debtor—again, at the court's discretion—where it is shown that management concealed or destroyed the accounting books of the bankrupt firm, embezzled or concealed part of the firm's assets, fraudulently caused the firm to lever up its debt, or failed to declare cessation de paiements within the required 15-day period. <sup>168</sup> Civil sanctions range from economic (e.g., forced divestiture) to civil (e.g., the loss of civil rights including inter alia the right to vote, the right to hold elected of-

<sup>163.</sup> See generally Moquet Borde & Associés, supra note 118, at 164–66; Anker Sørensen & Jane Sandilands, France, in Directors' Liabilities in Case of Insolvency (Anker Sørensen ed., 1999); France, Droit et Affaires, 8–10 (January 1998); Martine Dizel Chanfreau, Droit de l'Entreprise en Difficulté, 104–17 (1999).

<sup>164.</sup> To some degree, the punitive aspects of director liability for insolvency are a vestige of an older attitude towards defaulting debtors that criminalized bankruptcy law as a moral fault. As the economic importance of insolvency—as well as the awareness that insolvency was sometimes an exogenous and inevitable phenomenon—became obvious to lawmakers, the legal framework changed drastically. Yet some elements of the old regime remain. See Paul J. Omar, European Insolvency Law 10–11 (2004).

<sup>165. 1985</sup> Law, supra note 119, art. 180; Sørensen & Sandilands, supra note 163, at 240; Gewelbe, supra note 124, at 202.

<sup>166.</sup> *Id.* at 204. *See, e.g.*, Judgment of the Cour d'Appel de Paris (May 23, 1997), *in* La Semaine Juridique 1997 Ed. E, No. 28–29 (holding parent company liable for subsidiary's liabilities because the parent's interference with subsidiary's operational freedom rendered it the manager-in-fact of the subsidiary).

<sup>167. 1985</sup> Law, *supra* note 119, art. 182; Sørensen & Sandilands, *supra* note 163, at 251–57; Gewelbe, *supra* note 124, at 204.

<sup>168. 1985</sup> Law, *supra* note 119, arts. 187–91; Gewelbe, *supra* note 124, at 203.

fice, and the right to be a member of a jury in criminal proceedings). <sup>169</sup> In some cases, a criminal court may bring charges against corporate managers if they have committed certain acts detrimental to the creditors. <sup>170</sup> The criminal sanctions are independent of the civil penalties, and both may be assessed simultaneously. <sup>171</sup>

The effectiveness of such laws depends on (1) effective enforcement and (2) ensuring the threatened penalty is directed to the agents whose behavior is at issue—in this case, the corporate managers. As to enforcement, the reform in 1985 ushered in a period of lax enforcement relative to what had occurred under the earlier 1967 statute.<sup>172</sup> The abated enforcement of director liability statutes resulted from modified policy directives and as one French *tribunal commercial* judge remarked, "is actually a rare occurrence today."<sup>173</sup> The level of scrutiny is arbitrary, though the Minister of Justice has instructed public prosecutors to be diligent in larger cases where the sum of the debts exceeds a certain percentage of the company's annual turnover.<sup>174</sup> The vast majority of the over 40,000 French bankruptcies, then, lack effective enforcement of director-liability laws.

The directional issue—who is the ultimate penalty directed against?—is more complex. Obviously, director-liability laws aim to assess penalties on directors and force them to reconsider unlawful behavior in light of potential criminal and civil sanctions. The civil sanctions, however, only achieve their goal of disincentivizing managers' behavior if management is unable to opt out of liability through D&O liability insurance contracts. Originally considered illegal by many French courts, which held that state-imposed penalties were uninsurable, such contracts are widely available today.<sup>175</sup> The policies vary, naturally, and may not cover all possible civil penalties, but the insurability of some penalties undoubtedly attenuates much of the coercive effect of the director-liability laws.<sup>176</sup> By spreading the risk among many directors, the behavior-modifying effect is diluted so as to be purely ineffective. What

<sup>169.</sup> *Id*.

<sup>170.</sup> *Id.* at 204. Criminal sanctions include potential prison sentences of five to seven years as well as substantial monetary penalties. Sørensen & Sandilands, *supra* note 163, at 266.

<sup>171.</sup> Id

<sup>172.</sup> Koral & Sordino, supra note 122, at 440.

<sup>173.</sup> Id

<sup>174.</sup> Sørensen & Sandilands, supra note 163, at 240.

<sup>175.</sup> Benoît Garrigos, Risques Juridiques des Managers, Quelles Responsabilités?, (paper presented at Colloquium of Groupe de recherche en Economie et Management des Organisations, 16–18 (June 18, 2004), available at http://www.esdes-recherche.net/ESDES% 20-%20GEMO%20(F)/docs/PDF/2\_4.pdf (last visited Apr. 13, 2005); see also Insol International, supra note 113, at 214.

<sup>176.</sup> Id. at 18.

remains, then, is a bundle of "hollow sticks": a limited set of uninsurable criminal and civil penalties that lack zealous enforcement mechanisms.<sup>177</sup>

#### B. French Bankruptcy Law and Agency Conflicts

I have sketched a rough outline of the French bankruptcy laws and can now analyze the agency conflicts they create between debtholders and management. French law differs from Chapter 11's treatment of corporate agents in two dramatic aspects: (1) management and equity are expelled from the bankrupt firm; and (2) lawmakers have chosen to incentivize management by threatening civil and criminal sanctions for director malfeasance. The net result is that management has no ex ante incentive to file for redressement protection.

The dramatis personae of *redressement* proceedings are not the familiar cast of stakeholders from Chapter 11, since it is the judge and the administrator—and not the corporate stakeholders—who determine the form the reorganization will take. The opportunities for management and equity involvement in these proceedings are virtually nonexistent. The existence of extensive criminal and civil sanctions for failure to file highlights the 1985 Law's anti-management bias; after all, if managers had sufficient incentive to file timely relief petitions and preserve going concern value, French law would not have to threaten them for not doing so. As for equity, even if it is able to exert some control over management, its efforts are unlikely to have any effect on the disposition of the case. Unlike Chapter 11, there exist very few incentives for managers to file for bankruptcy protection or to otherwise make value-maximizing decisions and investments when a firm enters financial distress.

If French law prohibited the enforceability of insurance contracts dealing with director liability, it would no doubt increase the efficacy of the "stick" approach. The U.S. bankruptcy laws prohibit the waiving of certain pro-debtor elements of the reorganization proceedings. For example, many courts have held that a debtor may not enter into a prepetition waiver of the automatic stay imposed by 11 U.S.C. § 362(a). See Mark F. Hebbeln, Prepetition Waivers of the Automatic Stay in Bankruptcy: The Economic Case for Nonenforcement, 115 Banking L.J. 126, 126-27 (1998). Another example is the unenforceability of an ipso facto clause. An ipso facto clause is a "contract clause . . . designed to effect a forfeiture or modification of the Debtor's rights when a bankruptcy is filed." Michael D. Fielding, Preventing Voluntary and Involuntary Bankruptcy Petitions by Limited Liability Companies, 18 BANKR. DEV.J. 51, 53 (2001). The U.S. Bankruptcy Code renders such contracts unenforceable in five different sections. See id. Just as U.S. law prohibits waiving the "carrot," it would appear desirable for French law to prohibit waiving the "stick." A structural problem, discussed more at length at note 172, supra, would still remain, however. Managers would have no incentive to maximize firm value beyond avoiding proscribed conduct. Since it is impossible to prohibit all value-minimizing conduct without unnecessary and significant intrusions on management's ability to run a firm, some degree of malfeasance will always escape liability.

The incentives that do exist come from civil and criminal punitive measures. The French solution to the agency conflicts in insolvency—and by no means are the French alone in applying this strategy<sup>178</sup>—involves sticks rather than carrots. The problems with such an approach are both structural and enforcement-related. The structural problem results from the fact that a manager's incentives in such a regime are to comply with the laws in order to avoid liability, which is not always in the best interests of the firm's creditors. If the law-either criminal or civil-could anticipate all potential instances of managerial abuse, and if there were no evidentiary or enforcement problems, then the French system would put managers in the best position to timely steer the firm into bankruptcy. We know, however, that these laws are by their nature crude and underinclusive and that managers will be able to maneuver around the edges of liability, pursuing their own interests at the expense of the firm's interests. Punitive laws, in essence, cannot include the universe of possible nonvalue maximizing behavior; hence, such laws give managers the green light to do anything that does not fall within the explicit proscription contained in the law.<sup>179</sup> Management has no incentive whatever to maximize value in financial distress beyond avoiding types of prohibited conduct.

To illustrate this structural problem, consider that the effectiveness of the proscription "though shalt not kill" depends in part on its proscribing a forbidden result that can be achieved in innumerable ways. Director liability laws, in contrast, proscribe narrow ranges of conduct with the aim of curtailing a similarly broad phenomenon of "losing other people's money." Of course, the French could remedy this problem by adopting the framework of the murder proscription (i.e., an outright ban on achieving a harmful result). A legal regime which punished managers for losing money would have the collateral consequence of chilling any risk-taking behavior. Risky economic decisionmaking—unlike bodily harm to human beings—is at once desirable and pernicious. Put differently, no one worries that by prohibiting murder we are actually reducing the number of non-fatal batteries (indeed, such collateral consequences may be intended), but it would disturb us greatly if by punishing the undesirable result of poor performance we chilled significantly all economic

<sup>178.</sup> See generally INSOL INTERNATIONAL, supra note 113.

<sup>179.</sup> Cf. Myers, supra note 11, at 96. The author, discussing management compensation schemes that provide incentives for agents to align their interests with principals, stresses the impossibility of pinpointing criteria which are objective measurements of agents' success: "Even if good performance on these dimensions were observable by some informed monitor, the performance would not be verifiable. A contract offering a bonus for, say, 'good decisions' would not be enforceable, because the decisions could not be evaluated by a disinterested outsider or by a court of law." Id. Similarly, there is no reason to expect courts of law to evaluate what a bad decision is, and many bad decisions no doubt go unobserved and unverified under French director liability law.

risk-taking. The structural problem of sanctions in the context of insolvency is that the laws are either too broad, chilling vital risk-taking, or are too narrowly drawn and fail to deter bad investment decisions.

In addition to the structural problem, we also have seen that the enforcement of French director liability laws is weak and that many of the legal penalties can be insured against. When equity is not acting as management itself, it can be expected to pressure management to engage in asset substitution in the period leading up to bankruptcy. Equity—to whom liability is unlikely to attach—will do whatever is in its power, including higher compensation packages, to avoid turning over the company to the court. So while equity exerts pressure on management, the liabilities (the "sticks") French law imposes on directors do not, by and large, provide a strong incentive for directors to file for *redressement* protection.

It is not surprising, in this context, to find a high percentage of bank-ruptcies being channeled to judicial liquidation instead of redressement. The stated goal of firm survival may be subverted by management's perverse incentives to sail the firm into harm's way rather than guide the damaged ship into the protective harbor of redressement. As one French parliamentarian remarked recently, "numerous commentators have noticed that, in most cases, the managers refuse to recognize their difficulties, even when they are clearly in the cessation de paiements period." Once management can convince itself that it is unlikely to incur liability, "anything goes." Creditors and employees are left to suffer the consequences.

The frequency of liquidation impugns the efficacy of the French approach even more in light of the legal obligation to file for *redressement* within 15 days of *cessation de paiements*, which should mean that many viable companies with temporary cash flow shortages should be filing! Remember, after all, that the administrator and the tribunal are statutorily

<sup>180.</sup> See supra note 155 and accompanying text.

<sup>181.</sup> See supra note 14 and accompanying text.

<sup>182.</sup> See supra notes 137–141 and accompanying text. For a colorful anecdote illustrating the inefficacy of redressement, consider the example of former Prime Minister Jean-Pierre Raffarin's reaction to the restructuring negotiations over the future of the large Alstom group: "I am confident because we have let the world know that it would be a catastrophe to let Alstom end up in bankruptcy ["au dépôt de bilan," or "filing of the balance sheet"]. Alstom has more than 120,000 workers ... [and] formidable human capital, and then also some necessary industrial centers for transport and energy, not merely for France but for Europe as well." Intervention sur M6 dans le cadre de l'émission Zone Interdite (Sep. 23, 2003), available at http://www.archives.premier-ministre.gouv.fr/raffarin\_version1/fr/ie4/contenu/40679.htm. (last visited March 26, 2005) (translations by author).

<sup>183.</sup> Janine Jambu, 165th session of the Assemblé Nationale, Mar. 3, 2005, available at http://www.assemblee-nationale.fr/12/cri/2004-2005/20050165.pdf (last visited Apr. 22, 2005).

obligated to avoid liquidation where the bankrupt company's prospects for rehabilitation are not "manifestly impossible." Conversely, managers may avoid the filing requirement altogether by simply maintaining cash flow solvency but leveraging the company impossibly high. 185

It is not altogether clear whether the French system even protects employees in the final analysis. Once the court commences redressement judiciaire, the state is in charge, and it will do everything within its power to achieve its goal of avoiding job losses. In contrast to Chapter 11, though, the 1985 Law accomplishes nothing in terms of aligning the debtor's interests with the employees' interests ex ante. By relegating creditors to the recovery of judgments after bankruptcy and nominal payments spread out over ten years, the cost of capital for French corporations no doubt rises, which could stunt economic and employment growth. But most importantly, the predominance of liquidation bankruptcies testifies to the fact that firms are not successfully reorganizing and jobs are being lost.

# C. Moving Towards Twilight?: Proposed French Reforms Emulate Chapter 11 Structure

On January 26, 2004, the French Ministry of Justice disclosed its much-anticipated proposal to overhaul French bankruptcy law (projet de loi de sauvegarde des enterprises). The Council of Ministers adopted the proposals in May 2004, and the Assemblée Nationale (lower house of French parliament) adopted the law on March 9, 2005. The Sénat subsequently adopted the law as well, which was quickly (and unsuccessfully) challenged in the French Conseil Constitutionnel by Socialist Party senators who complained the law aggregated too much

<sup>184.</sup> See Wu, supra note 137, at 262, and accompanying text.

<sup>185.</sup> Calisto Tanzi may have pursued just such a strategy in the global default of Italy's Parmalat group. By fraudulently concealing the company's true finances, the group was able to access debt markets and make minimum payments to its obligations, all the while digging the company into a deeper hole. Admittedly, the Parmalat example involved some egregious and persistent fraudulent conduct that several criminal and civil penalties address (indeed, Tanzi will likely spend time in prison). In principle, however, a management could—in the short term, at least—forestall cash flow insolvency by borrowing more money without engaging in conduct amounting to criminality.

<sup>186.</sup> Freshfields white paper, *supra* note 138, at 1.

<sup>187.</sup> The French Conseil Constitutionnel is a staggered body composed of nine members, each appointed for nine years. Every three years, three members are appointed. Former French presidents are also ex officio members of the Conseil. The Conseil's jurisdiction extends to constitutional challenges to proposed laws brought by the president, the prime minister, the presiding member of either house of the legislature, or by application of 60 or more senators or representatives (of the Assemblée Nationale).

power to bank creditors. The proposed reforms would create an additional procedure similar to Chapter 11: le sauvegarde de l'entreprise. The sauvegarde alternative is available to managers before the actual cessation de paiements stage. A court order would impose a stay on collection efforts (obviating the major obstacle to negotiations under the conciliation regime 191) and the firm could commence negotiations with its creditors. The court supervising the negotiations over the future of a large firm 192 will appoint two creditors' committees—one representing credit institutions and another representing trade creditors—that will vote to accept or reject a proposed plan. The court, however, may approve a sauvegarde plan over a committee's dissent. The introduction of committees would extend to the redressement proceedings as well.

Most notably, the *sauvegarde* laws permit management to retain control over the company and provide for a more limited charge for the administrator.<sup>196</sup> In fact, the *sauvegarde* mimics Chapter 11's exclusivity

- 188. The case brought by the Socialist senators was decided on July 22, 2005. The claimants contended that by a certain provision, allowing banks to achieve heightened priority when introducing new capital to bankrupt firms, the sauvegarde law violated the constitutional principle of equality. Banks would be permitted certain priority-enhancing actions to the detriment of the public—in the form of government creditors, social security investors, and unemployment insurance companies. Decision No. 2005-522 DC, Loi de sauvegarde des enterprises, para. 3 (July 22, 2005). It is worth mentioning in this regard that the disputed provision is yet another U.S. bankruptcy law analogue. 11 U.S.C. §364(d)(1) allows a debtor to obtain new credit by offering a senior secured position to a lender. Typically, the only lenders in position to extend such credit are the bank creditors, who are already familiar with the debtor's business and are often willing to throw new money in the pot to hopefully save their original investment.
  - 189. The sauvegarde, like Chapter 11, in this way promotes voluntary filings.
- 190. The other pre-cessation procedure available to French debtors—the conciliation process—is discussed supra in note 123. The new legislation expands the availability of conciliation even up to 45 days after cessation de paiements. As with the current version, however, there is no stay of collection imposed. See Law No. 2005-845 of July 26, 2005, J.O., July 27, 2005, art. 5 (art. L.611-4 of the Commercial Code) (2005), available at http://www.legifrance.gouv.fr/WAspad/UnTexteDeJorf?numjo=JUSX0400017L (last visited Sep. 9, 2005) [hereinafter Sauvegarde law].
  - 191. See supra notes 123 and 187.
- 192. Sauvegarde law, *supra* note 190, art. 83 (art. L.626-29 of the Commercial Code) ("Les débiteurs dont les comptes one été certifiés par un commissaire aux comptes ou établis par un expert-comptable et dont le nombre de salariés ou le chiffre d'affaires sont supérieurs à des seuils fixés par décret en Conseil d'État, sont soumis aux dispositions de la présente section). The thresholds have not been determined, and will be set by decree in the future. *Id*.
  - 193. *Id.* art. 83 (art. L.626-30 of the Commercial Code).
  - 194. Id. arts. 59, 83 (arts. L.626-1 and L. 626-31 of the Commercial Code).
  - 195. Id. art. 88 (art. L.631-1 of the Commercial Code).
- 196. *Id.* art. 23 (arts. L.621-4 and L.622-1 of the Commercial Code) ("L'administration de l'entreprise est assurée par son dirigeant."); see also Nouvelles Orientations pour la Sauvegarde des Entreprises, available at http://www.lawperationnel.com/Sauvegarde/loi\_sauvegarde\_Nouvelles Orientations.htm (last visited Apr. 30, 2005) ("Le chef d'entreprise n'est pas dépossédé durant cette procédure de ses prérogatives et l'administrateur nommé ne peut avoir qu'une mission de surveillance et d'assistance.").

period by providing a time lag of 30 days prior to the constitution of the creditors' committees and a two-month time lag before the debtor must present a plan to the committees.<sup>197</sup> The legislative history of the proposed reform testifies to debtor control as the driving purpose behind the legislation. During debate in the National Assembly, Xavier le Roux, a supporter of the bill, emphasized that under the new law administrators must respect their limited role and that "the managers maintain the responsibility for the [distressed] company's direction." The Finance Commission's rapporteur, Jérôme Chartier, provides in his report that "the logic of the bill is clear: to leave the managers themselves in charge of the business, with the administrator having nothing more than a supervisory, or assistant, capacity." The law aims to "responsabiliser" 200 the managers.<sup>201</sup> The report invokes the model of Chapter 11 repeatedly, as well as its goal-emphasized throughout this Note-of encouraging timely bankruptcy petitions: "For this reason, it is the manager himself who can commence, as soon as difficulties appear, the procedures envisioned by the bill."202 M. Chartier refers to Chapter 11—and le sauvegarde—as an "anticipated, negotiated, and simplified" redressement judiciaire.203

But if all goes well, the firm will not be forced into redressement and will be able to reach a compromise with its creditors' committees without too much heavy-handed interference by the administrator. By preserving management's control, the sauvegarde system grants it a stake in the firm's future, if it is willing to appease creditors. The goals of preserving going concern value and efficiently distributing assets (as well as preserving employment) are synchronized with the goal of reducing ex ante agency conflicts. Granted, by allowing management to retain control with a collection stay in place, sauvegarde creates new problems that are old hat for Chapter 11 (e.g., the costs of management's rent-seeking once bankruptcy has commenced). Inevitably, creditors of French bankrupts will invent methods akin to APR violations in order to purchase management's compliance (e.g., the "tax" discussed at Part

<sup>197.</sup> Sauvegarde law, supra note 190, art. 83 (art. L.626-30 of the Commercial Code).

<sup>198.</sup> Xavier le Roux, 168th Session of the French Assemble Nationale, Mar. 8, 2005, available at http://www.assemblee-nationale.fr/12/cri/2004-2005/20050168.asp#P491\_67301 (last visited Apr. 22, 2005).

<sup>199.</sup> Jérôme Chartier, Avis Presenté au Nom de la Commission des Finances, de l'Économie Générale et du Plan sur le Projet de Loi de Sauvegarde des Entreprises, Doc. No. 2099, Feb. 14, 2005, at Part II.A.2, available at http://www.assembleenationale.fr/12/rapports/r2099.pdf (last visited Apr. 22, 2005)

<sup>200.</sup> See Larousse French-English Dictionary 650 (1981) (defining "responsabiliser" as "to make aware of one's responsibilities").

<sup>201.</sup> Chartier, supra note 199, at Part II.A.

<sup>202.</sup> Id

<sup>203.</sup> Id. at Part II.B.1.

II.C supra). If the sauvegarde succeeds in reducing the number of liquidations, however, the ex ante efficiency effects regarding the filing decision are likely to outweigh the new agency problems. The new law recognizes that creditors (and employees) are better off transferring some value and control to managers in order to procure their cooperation than sifting through the slim pickings of a liquidation sale of a depleted firm.

A final note may be in order regarding where the sauvegarde reform fits in the historical development of the French bankruptcy law. If, as discussed above, academics and investors in the United States foresee a shift, already under way, away from equity and in the direction of enhanced creditor involvement in restructurings, it may seem odd to applaud France's adoption of a Chapter 11-type framework all the while the United States is jettisoning portions of that very system. Broad crossstate comparisons of financial and bankruptcy laws, however, can be misleading. Different states' stages of legal development are rarely in a tight parallel relationship, and the LLSV findings highlight the particular dissonance between French and Anglo-American law. It is also helpful in this regard to refer to the articles by Professors Pistor and Berkowitz explaining the importance of the "transplant effect" of legal rules, specifically their observation that the substance of legal rules sometimes matters less than the process by which those rules are integrated into a state's legal system. 204 Moreover, despite the recent overtures to management and equity, French bankruptcy law will still offer creditors and courts more discretion over the insolvent company than Chapter 11.

#### VI. Conclusions

The importance of agency conflicts and agency costs cannot be overestimated in the insolvency context. We have seen how managers and equityholders have interests adverse to the interests of creditors during times of financial distress and how, by deviating from the absolute priority rule in favor of equity, creditors can mitigate the conflicts and obtain both ex ante and ex post efficiency gains. Drawing on the already ample literature, I have presented an argument that a bankruptcy regime giving management (and by extension, more often than not, equity) control over the proceedings is more likely to preserve going concern value. New critiques that highlight leverage gains by creditors are helpful, but they do not explain away the agency problem: someone must still be in charge of the company and that someone is usually management, which

204. See supra note 115.

will demand payment in some form. Chapter 11 is by no means perfect, but calls for its wholesale abolition either underestimate the agency conflicts of insolvency or overestimate the degree to which private contracting has rendered those conflicts obsolete.

I then examined the French bankruptcy laws and found that those laws exacerbated agency conflicts in pursuit of a non-efficiency goal and attempted to address the agency conflicts outside of bankruptcy negotiations in the form of punitive sanctions. In so doing, the French system ossifies the conflicts that Chapter 11 aims to mitigate and subverts the very goals of firm survival and employee retention that the French system aims to promote. New French laws do, however, reflect some insights from Chapter 11 and agency theory and represent a significant step forward for France. The new sauvegarde procedure follows Chapter 11's example of providing ex ante incentives for management to file for protection and aims to secure more successful rehabilitations—and fewer liquidations—than the current failed redressement option. The recent overture in the direction of Chapter 11 is a welcome development for nearly all French commercial parties. The explicit reliance on Chapter 11 as a template for the new sauvegarde procedure recalls the important incentive structure for agents that lies at the heart of Chapter 11 and that any proposed bankruptcy reform ignores at its peril.