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REORGANIZATION WITHOUT BANKRUPTCY: UNTYING THE GORDIAN KNOT THAT DESTROYS FIRM VALUE

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This Article presents a new theory for analyzing bankruptcy-reorganization proceedings as well as a reorganization mechanism for public companies that may best meet legislative objectives: maximizing firm value and dividing it according to the claimants' legal priorities. Called Gordian knot theory, it suggests that there is a strong structural and material connection between reorganization stages, whereby bargaining and litigation between the claimants over the reorganization pie lead to progressive destruction of the firm's value and infringement on their legal rights. To demonstrate this theory, this Article focuses on reorganization's allocation and reallocation stages—where the claimants' original and new rights are determined, respectively—and how the connection between them prevents the legislative objectives from being met. Alternative approaches suggested for attaining these objectives, including Roe's, Bebchuk's, Baird's, Aghion, Hart and Moore's, and Adler and Ayres' models, have focused on the firm's valuation problem and suggested solving it by market mechanisms. The Gordian knot theory suggests, however, that it is impossible to attain the legislative objectives strictly by determining the firm's value efficiently while leaving allocation problems to bargaining and litigation.

This Article further presents a new mechanism for public companies that overcomes this problem by structuring reorganization in a single shot that

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includes the allocation and reallocation of rights, while eliminating the need for bargaining and court proceedings. It is based on a firm's going-concern warning that auditors have to issue, explicitly indicating that there is substantial doubt as to whether the firm could remain solvent over twelve months. Under this mechanism, the warning initiates twelve months of voluntary rehabilitation. Then, if the warning is still valid, the junior classes will be able to buy out all of the senior classes at a price of the latter's claims, similar to Bebchuk's options model. A successful buy erases the original debt and, if the claimants do not purchase the firm, it is considered insolvent. This Article presents this mechanism—called the reorganization without bankruptcy mechanism—and discusses its advantages: inter alia, *in the pre-bankruptcy period, the firm is solvent, it has not breached its contracts, and it is not involved in complex allocation disputes. These advantages bring the reorganization process in line with the legislative objectives, and allow firms to achieve rehabilitation by allowing for funding based on market mechanisms and management's sole discretion, providing management with incentives for adequate disclosure, and initiating rehabilitation based on objective criteria—all free of bargaining and litigation biases.*

INTRODUCTION

A. *The Main Research Questions, the Law, and Prevalent Approaches*

This Article explores the bankruptcy reorganization process and presents a theory for analyzing it and a mechanism that may best achieve its main objectives—maximizing firm value and dividing it according to the claimants' legal priorities. My main research questions focus on the reorganization's ability to attain those objectives, especially for public companies. First, if the current process fails to achieve its purposes, why is that the case, and could this failure occur under alternative reorganization mechanisms suggested by the literature? Second, what mechanism can the law adopt to achieve its main objectives?

To answer the first question, this Article presents the *Gordian knot theory*, which shows that bargaining and litigation over the allocation of claimants' rights prevent the legislative objectives from being achieved, and that the lack of an efficient allocation mechanism of claimants' rights within the bankruptcy process makes any reorganization mechanism inefficient. To answer the second question, I propose the reorganization without bankruptcy mechanism to operate when the firm is still solvent, has not yet breached its contracts, and has not yet entered into complicated legal disputes over claimants' rights—so that the main objectives of the bankruptcy reorganization process may still be achieved.

When a company becomes insolvent, the existing law enables it to file for bankruptcy under two main proceedings: reorganization or liquidation.[1] This Article focuses on the for-

1. *See, e.g.*, Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986) [hereinafter Baird I] (presenting his auction method, which he revisited in Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993) [hereinafter Baird II]); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 775–76

mer. Reorganization refers to collective proceedings of debt repayment to the failing firm's creditors that are characterized by a process of the firm's hypothetical sale to reveal its value and division of rights in the rehabilitated firm among claimants.[2] Under bankruptcy law, claimants should receive rights in the rehabilitated firm according to the absolute priority principle (APP) which preserves their pre–bankruptcy legal rights. According to this principle, the secured creditors receive their rights first, followed by the unsecured creditors, and if any value remains to be divided, the equity holders receive their residual claim.[3] In the United States, Chapter 11[4] of the Bankruptcy Reform Act of 1978 (hereinafter Bankruptcy Code) governs firms' reorganization. Bebchuk summarized the benefits of reorganization as follows: "[R]eorganization is thought to be especially valuable when (i) the company's assets are worth much more as a going concern than if sold piecemeal, and (ii) there are few or even no outside buyers with both accurate information about the company and sufficient resources to acquire it."[5]

Under Chapter 11, a firm is sometimes sold as a going concern, even before the approval of a reorganization plan.[6] The literature has debated the pros and cons of a formal reorganization or a sale as a going concern.[7] Rather than assess these pros and cons, this Article will examine whether there is

(1988) [hereinafter Bebchuk I] (presenting his options model); Lucian A. Bebchuk, *Using Options to Divide Value in Corporate Bankruptcy*, 44 EURO. ECON. REV. 829, 829–30 (2000) [hereinafter Bebchuk II] (revisiting the presentation of his options model). For the presentation of Bebchuk's options model and Baird's auction method, see *infra* Section I.D.2 and I.D.3, respectively.

2. *See, e.g.*, Baird I, *supra* note 1, at 127; Bebchuk I, *supra* note 1, at 775–76.

3. For a discussion of APP and its application in Chapter 11, see *infra* Sections I.C and II.A.1.

4. 11 U.S.C. §§ 1101–1174 (2021).

5. Bebchuk I, *supra* note 1, at 776.

6. For a discussion on reorganization sales as a going concern, see *infra* Section I.C.2.

7. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751–56 (2002); 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 (2003). For Baird and Rasmussen's claims that going-concern sales of large firms have become a common practice, and LoPucki's arguments that sales under Chapter 11 proceedings might be "fire sales" and

a structural deficiency in the bankruptcy process that often prevents it from meeting legislative objectives, and whether a possible solution may be offered.

Another option is for an insolvent firm to liquidate. Liquidation, governed by Chapter 7 of the Bankruptcy Code,[8] is appropriate for companies that are unsuitable for rehabilitation, and consists of a going-concern sale or an asset sale. The sale's return is then divided between creditors according to their priorities.[9]

Section I presents the law of reorganization and the literature that discusses its objectives, structure, operation, and costs. The literature focuses on what it considers the main problem of reorganization proceedings: determining the rehabilitated firm's value accurately and promptly.[10] This value is essential for the distribution of rights among claimants, as well as for ensuring that the reorganization preserves more value than liquidation.[11]

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that debtors who reorganize have substantially higher recovery ratios than debtors who sell, see *infra* Section I.C.2.

8. 11 U.S.C. §§ 701–784 (2021).

9. *See, e.g.*, Baird I, *supra* note 1, at 127; Bebchuk I, *supra* note 1, at 775. Baird and Rasmussen claimed that sales should govern the rehabilitation of large firms. *See* Baird & Rasmussen, *supra* note 7; *infra* Section I.C.2.

10. *See, e.g.*, Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganizations*, 83 COLUM. L. REV. 527 (1983); Bebchuk I, *supra* note 1, at 777–78; Bebchuk II, *supra* note 1, at 831; Baird I, *supra* note 1, at 136; Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83, 85 (2001); Douglas G. Baird & Donald S. Bernstein, Absolute Priority, *Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1935 (2006).

11. *See, e.g.*, Bebchuk I, *supra* note 1, at 777 ("If such a figure were available, the distribution of tickets in the reorganized company would be easy to determine. Without such a figure, however, it is difficult to decide where, down the rank of creditors and preferred shareholders, it is necessary to stop issuing tickets in the newly reorganized entity."); Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1252 (1981) ("Whenever the going-concern value of an insolvent debtor's business exceeds its piecemeal liquidation value, and the receivership preserves that excess value, there is a net gain for creditors and society. But this efficient procedure creates a new valuation problem, for the receiver or the supervising court must decide whether going-concern value does in fact exceed liquidation value.").

In principle, the task of determining firms' value can be performed by three methods.[12] First, a court valuation hearing was the path taken by Chapter X of the Bankruptcy Act of 1938, which governed U.S. firms' reorganization until 1978. Chapter X did not allow deviation from APP, but evidence showed that the valuation hearings dramatically reduced the rehabilitated firms' value, leading to the 1978 reform.[13] Second, structured bargaining is the method taken by Chapter 11 which left the determination of a reorganization plan (that reveals the firm's value) to a solution by negotiation between the firm and the claimant classes, under court supervision. As discussed in Section I, the literature shows that this method involves the costs of the firm's value destruction and deviations from the claimants' rights. Third, the firm's value could be determined by a market-based mechanism, including a sale. As aforementioned, Chapter 11 reorganization proceedings sometimes involve the sale of the firm as a going concern.[14] The literature that discusses this alternative and debates its efficiency has found that after 2000, senior creditors have gained increased control in Chapter 11 cases and that this phenomenon contributes to "fire sales": increased and hurried firm sales under terms that do not benefit all creditors.[15] Based on empirical findings, the literature argues that the rise of institutional investors and their resulting power leave very little to junior creditors.[16]

Starting with Roe in 1983 and Bebchuk in 1988, the literature has suggested alternative market mechanisms to attain legislative objectives. Roe suggested determining the firm's value by selling a fraction of the reorganized company's shares

12. *See* Roe, *supra* note 10, at 528–33, 536–48, 592; Bebchuk I, *supra* note 1, at 777–81, 789–90.

13. *See* references in *infra* notes 44–50 and accompanying text.

14. For a discussion of reorganization sales as a going concern, see *infra* Section I.C.2.

15. For discussion and references on the institutional creditors' increased control in Chapter 11 cases and its connection to "fire sales," see *infra* Section I.C.2(a).

16. For the presentation of the reorganization proceedings' costs in the various eras, see *infra* Section I.C. For the conclusion that in reorganization proceedings only very little is left to junior creditors, see, for example, COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 215 (2014), http://commission.abi.org/full-report [hereinafter *ABI Reform*].

in the stock market (hereinafter Roe's partial sale).[17] Bebchuk proposed selling the company's ownership to its claimants, based on a transformation of the original claims against the firm into options that would allow junior classes to buy senior claims at the price of those claims (hereinafter Bebchuk's options model).[18] Baird suggested auctioning failing public companies shortly after they file for bankruptcy (hereinafter Baird's auction method).[19] Aghion, Hart, and Moore suggested that after filing, the different classes of claims transform into homogenous shares, using Bebchuk's options model, and in a second stage, the firm is sold in an auction (hereinafter Aghion, Hart, and Moore's model).[20] Finally, Adler and Ayres offered a dilution mechanism to grant senior creditors all of the shares and allow junior classes to buy new shares until there is no excess demand for the stock (hereinafter Adler and Ayres' model).[21]

B. *The Gordian Knot Theory of Bankruptcy Proceedings*

Section II presents the Gordian knot theory of bankruptcy and suggests that there is a strong structural and material connection between the bankruptcy proceedings' different stages where, at one or several stages, bargaining or litigation between the claimants over the distribution of the reorganization pie leads to progressive destruction of the firm's value or infringement on their legal rights.

To demonstrate this theory, I focus on two main stages, or processes, of Chapter 11 proceedings: (1) the *allocation stage* (AS) that deals with classifying creditors' rights by their priorities and determining each creditor's debt;[22] and (2) the *reallo-*

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17. Roe, *supra* note 10, at 530. But the literature has indicated that selling a small part of the company incentivizes manipulations that impair the buyers' ability to determine the firm's value. *See, e.g.*, Adler & Ayres, *supra* note 10, at 144.

18. *See* Bebchuk I, *supra* note 1, at 781–95; *see also* Bebchuk II, *supra* note 1, at 829.

19. *See* Baird II, *supra* note 1, at 634.

20. *See* Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 524 (1992) [hereinafter Aghion, Hart & Moore I]; Philippe Aghion, Oliver Hart & John Moore, *Improving Bankruptcy Procedure*, 72 WASH. U. L. REV. 849, 862 (1994) [hereinafter Aghion, Hart & Moore II].

21. Adler & Ayres, *supra* note 10, at 85.

22. *See* discussion *infra* Section II.A.1 on the allocation stage.

cation stage (RS) where the management prepares a reorganization plan that determines the firm's value and transforms the original claimants' rights into new ones in the rehabilitated firm. Then, the court may approve the plan for voting, the claimers' classes can vote on its approval, and finally the court may confirm the plan after hearings.[23]

This Article will show that, under Chapter 11 proceedings, the AS and RS are structurally parallel and materially essential stages of the negotiation between the same participants regarding the division of the same pie. They are both overseen by court hearings, including joint litigation on the approval of the disclosure statement prior to convening the classes' meetings to vote on the reorganization plan, and joint litigation after the meetings to approve it. Furthermore, the literature describes factors that lead to the reorganization plan resulting in a firm's value destruction and infringement on claimants' rights.[24] This Article presents additional factors arising from the litigation and bargaining for settlement that result in biased settlement arrangements—for example, asymmetric litigation costs and asymmetric information.

In light of this proposed theory, I examine whether alternative mechanisms suggested by the literature, which focus on solving the firm's valuation problem with market mechanisms, can achieve the legislative objectives.[25] I claim that solving allocation problems is crucial for all Chapter 11 filings or alternative mechanisms and that it is impossible to attain the legisla-

23. *See* discussion *infra* Section I.C on the reallocation stage.

24. *See* discussion and references *infra* Section II.A.2 on these factors.

25. There are additional suggestions for reforms that are not presented here. Some of them are voluntary alternatives to the current proceedings, which seem to be very difficult to implement (for the same reasons that make the bargaining difficult after the commencement of the bankruptcy proceedings). For example, Rasmussen suggested that companies be allowed to choose the applicable law from a "menu." Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100 (1992). Adler suggested a voluntary alternative to debt collection based on a contractual collective-action mechanism that enables creditors to issue "chameleon equity"—debt that would be converted to equity when the firm is unable to cure a default. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323–24 (1993) [hereinafter Adler, *Financial and Political Theories of American Corporate Bankruptcy*]; Barry E. Adler, *The Creditors' Bargain Revisited*, 166 U. PA. L. REV. 1853, 1856–59 (2018) [hereinafter Adler, *The Creditors' Bargain Revisited*].

tive objectives by leaving allocation problems to bargaining and litigation, even if reallocation problems are solved efficiently.[26] The former may reduce the reorganized firm's value and lead to settlement biases, even if followed by an effective RS. I argue that where most bargaining and litigation over the claimants' rights occur after a sale, as proposed in Baird's auction method, or by a Chapter 11 sale, the same outcomes follow and the legislative objectives cannot be achieved.

C. *A New Mechanism for Public Companies' Reorganization: The Reorganization Without Bankruptcy Mechanism*

Section III presents a new mechanism that may overcome the Gordian knot problem. It is based on a firm's going-concern warning (GCW)—a type of going-concern opinion (GCO) that auditors have to include in firms' financial statements, indicating explicitly that there is substantial doubt whether the firm could remain solvent over twelve months.[27] Under this mechanism, issuing the warning initiates twelve months of voluntary rehabilitation and, if necessary, reorganization. Under the proposed law, an option to purchase the company is offered to the equity holders and the company's credit suppliers, i.e., the unsecured and secured creditors. If the GCW is still valid by the end of the voluntary rehabilitation period, the claimants, in order to preserve their rights, will have the option of purchasing the firm, similar to Bebchuk's options model.[28] The proposed law would in effect add the rights described to the claimants' original contracts. If neither class acquires the firm, the firm is then considered insolvent.

In this Article, I present the reorganization without bankruptcy mechanism and discuss its advantages. Some of the advantages derive from severing the Gordian knot that locks together the allocation and reallocation processes.[29] First, in the pre-bankruptcy period, the firm is solvent and it has not

26. *See* discussion *infra* Section II.C.1 on Bebchuk's explanation that his options model should be operated after determining the claimants' rights.

27. *See* discussion *infra* Section III.D.3 on the definition of the term going-concern warning (GCW) and the conditions for its issuance under the proposed reorganization without bankruptcy mechanism.

28. The reorganization without bankruptcy mechanism could be adjusted so that it is based on alternative efficient valuation and reallocation mechanisms, including auction.

29. *See* discussion *infra* Section III.B.

breached its contracts. Therefore, it does not have unpaid debts nor complex allocation disputes that lead to the destruction of its value and deviations from claimants' legal rights. The reorganization plan only includes the equity holders and the company's credit suppliers, whose original rights can be determined relatively easily, especially at this time. Therefore, attaining the legislative objectives is possible.

Second, under these terms, the allocation of original rights can be fully based on the securities' trading system, the company's financial statements, and its accounting system. The firm's valuation and the liquidation needed for the options' execution may be provided by the securities market's efficient mechanisms[30] and, to refine them, it may be possible to register unlisted debt for trading.

Third, the repayment of financial liabilities by the plan may give the company the fresh start it needs.

Fourth, by leaving the recovery process to the sole discretion of the management, the focus can be put on making operational and financial changes that will maximize the company's value and attract potential investors. Thus, in an environment free of the strategic behavior typical of parties in Chapter 11 bargaining and litigation, without restrictions deriving from breach of contract litigation and lenders' reluctance to fund insolvent companies funding, the likelihood of the firm's rehabilitation is high.

Fifth, by operating the mechanism so that the management can continue rehabilitating the company in the twelve months following the issuance of the warning, only the failure to change its situation would lead to the firm's formal reorganization plan and the transfer to the claimants. I argue that, to prevent manipulations by the claimants and management and to deal with a failing management, it may be sufficient to enable a majority of uninterested claimants of a class (claimants who do not hold claims in a preferred class) to predate the reorganization plan.[31]

Sixth, the literature explains that workouts can potentially fail due to investors' lack of information regarding the man-

30. *See* Andrew W. Lo, *Efficient Markets Hypothesis*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECON. 782–91 (Steven N. Durlauf & Lawrence E. Blume eds., Palgrave Macmillan, 2008)

31. *See* discussion *infra* Section III.C.

agement's disclosure and purposes.[32] Under the proposed mechanism, these investors would know that the mechanism prevents the destruction of the firm's value and deviation from the APP in the case of a formal reorganization plan. This may restore investors' confidence in the management's rehabilitation plans in the post-warning period and increase their chances of success.

Seventh, using objective criteria to determine the initiation of the mechanism might save the Chapter 11 initiation costs caused by bargaining and litigation at this stage. Furthermore, since the proposed mechanism does not allow for deviation from the APP, it would reduce secured creditors' or shareholders' pressure on the management to act in their favor and may restore the management's incentives to truthfully disclose the company's situation that gives rise to discussion on the registration of a GCO.

To complete the picture, Section IV discusses the possible *disadvantages* of the suggested mechanism and presents questions for further research. Finally, the Conclusion presents the promise held by the new theory and proposed mechanism.

I.
Reorganization Law and Alternative Mechanisms

A. *The Legislative Objectives*

To define the objectives of the reorganization process, I follow Bebchuk's focus on the two main objectives of ex-post and ex-ante efficiency effects.[33] *Ex-post efficiency* has the objec-

32. *See* discussion and references *infra* Section I.E.2 on reasons for possible failure of workouts.

33. For a discussion of the maximization of the firm's value and preserving the APP as the main objectives of the bankruptcy proceedings, see Bebchuk II, *supra* note 1, at 831; Lucian A. Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy,* 57 J. Fin. 445, 445–48 (2002) [hereinafter Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*]. Most of the literature shares the same conception of the main legislation objectives of bankruptcy proceedings, including Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L.J. 857, 868 (1982); Adler & Ayres, *supra* note 10, at 85–96; *ABI Reform*, *supra* note 16, at 3 (acknowledging the importance of these legislative objectives). Aghion, Hart and Moore included these two objectives in their presentation of bankruptcy goals and added two more: give managers the right ex-ante incentives to avoid bankruptcy and put decisions in the hands of claimants and not outsiders (such as judges). Aghion, Hart & Moore II, *supra* note 20, at 851–54.

tive of maximizing the firm's value during the bankruptcy process and issuing rights in the firm to the most efficient hands. Maximizing the firm's value efficiently requires regulators to design the process in a way that allows for the determination of the firm's value in a timely manner, with low direct and indirect costs, leading to minimal destruction of value. Furthermore, the proceedings should lead to the reallocation of the rights in this firm to the most efficient user.

Ex-ante efficiency has the objective of optimal division of the firm's value in a way that preserves claimants' post-commencement legal rights. Destruction of firm value as well as deviations from APP might lead to impairments in post-commencement legal rights, and accordingly, to disruptions in pre-bankruptcy markets. In all markets and transactions, consumers and suppliers adjust their contracts to account for the possibility of impairment in their rights; for example, banks might require higher loan rates and this might affect the costs of goods and services, including capital, for all firms.

B. *The Firm's Valuation Problem*

The literature has extensively discussed the necessity of and problems with firms' bankruptcy proceedings.[34] In pioneering research, Jackson described the strategic behavior of claimants who bargain to receive their rights toward a firm that has financial difficulties as a common pool problem.[35]

There are, however, claims in the literature that deviations from APP may also be beneficial. For a review of this literature, see Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, *supra*, at 446. Baird, Casey & Picker argued that the bankruptcy proceedings' objective is to maximize the firm's value, and that to follow this objective, there is little room for departures from bankruptcy's distributional rules. *See* Douglas G. Baird, Anthony J. Casey & Randal C. Picker, *The Bankruptcy Partition*, 166 U. PA. L. REV. 1675, 1676–79 (2018). Finally, Jacoby argued that bankruptcy objectives should include advancing public norms. *See* Melissa B. Jacoby, *Corporate Bankruptcy Hybridity*, 166 U. PA. L. REV. 1715, 1716–17 (2018).

34. *See, e.g.*, Roe, *supra* note 10, at 528–30; Baird I, *supra* note 1, at 128; THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 1–2 (1986); Bebchuk I, *supra* note 1, at 775; Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy, supra* note 25, at 311–12; Francisco Cabrillo & Ben W.F. Depoorter, *Bankruptcy Proceedings, in* 5 ENCYCLOPEDIA OF LAW & ECONOMICS 261 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

35. Jackson, *supra* note 33, at 861–65; JACKSON, *supra* note 34, at 10–11. *See also* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of*

When the firm faces difficulties, it may be in the best interest of the claimants to act collectively to maximize the firm's value and their share of the pie. Each creditor, however, has an interest in acting individually and aggressively to maximize their own share, out of fear that other creditors would do the same. Accordingly, the main effort of bankruptcy law is to coordinate creditors' procedures to retain their rights.[36] In this role, the law functions as insurance for all creditors.[37] Another role of bankruptcy law is to "help a firm stay in business when it is worth more to its owner alive than dead."[38]

The literature discusses the question of which is the preferred route: reorganization or liquidation? As mentioned above, the convention is that reorganization may best preserve the firm's additional value derived from its existence compared to its liquidation and that it may enable the firm to overcome the negative financial effects of its operation and funding.[39] Others argue, however, that reorganization proceedings

Secured Creditors in Bankruptcy, 51 U. CHI. L. REV. 97, 100–101 (1984); BARRY E. ADLER, DOUGLAS G. BAIRD & THOMAS H. JACKSON, BANKRUPTCY – CASES, PROBLEMS, AND MATERIALS 24 (4th ed. 2007). Jackson and Baird's articles are considered the foundation for the bargaining theory of bankruptcy that focuses on the social costs and the failures of bargaining between the claimants and the firm to achieve maximum value to the firm and to preserve the participants' rights. *See, e.g.*, David A. Skeel, Jr. & George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1177 (2018). For a contract theory of bankruptcy that focuses on the advantages of freedom of contracts between the parties to the company's nexus of contracts for efficiently resolving interferences in those contracts, see, for example, Rasmussen, *supra* note 25, at 53; Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127 (1997); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1809 (1998); Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343, 346–48 (1999); Skeel & Triantis, *supra*. Casey presented a new bargaining theory whereby the sole purpose of bankruptcy law is to solve the incomplete contracting problem arising from the firm's financial difficulties. Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709 (2020).

36. *See* Jackson, *supra* note 33, at 857–58; ADLER, BAIRD & JACKSON, *supra* note 35.

37. ADLER, BAIRD & JACKSON, *supra* note 35, at 22.

38. JACKSON, *supra* note 34, at 2. *See also* ADLER, BAIRD & JACKSON, *supra* note 35, at 28.

39. For the main convention of reorganization proceedings' justifications, see Bebchuk I, *supra* note 1, at 776.

are too costly and unnecessary and that asset sales should govern firms' insolvency.[40]

As mentioned above, the literature identified the task of determining the firm's value as the major problem of reorganization proceedings.[41] This literature explains that in times of financial distress, it is difficult to estimate the future value of the rehabilitated firm, being a fictional value of a theoretical sale, and that there is a conflict of interests between the creditor classes regarding this value. To maximize their share of the rehabilitated firm, the secured creditors have an incentive to claim that the firm's value is no more than the amount of secured debt, while at the other end, the shareholders will argue for it being as high as possible.[42]

In principle, the task of valuing a rehabilitated firm can be performed using three methods: court valuation hearings, structured bargaining, and market mechanisms.[43] Valuation hearings were at the core of Chapter X, which governed the reorganization of U.S. firms, until 1978.[44] Chapter X required management to be replaced by an appointed trustee,[45] which could have caused management to withhold bad news and delay the bankruptcy filing. Chapter X also required valuation hearings to determine the future reorganization value of the firm and did not permit deviations from the APP, "requir[ing] that each class be compensated fully before any junior class could participate."[46]

When Congress discussed the 1978 reform, it was clear that "valuation hearings were costly, time-consuming, and often disastrous" and that "[a]s [has] frequently been pointed out in connection with the need for a valuation hearing, or diagnosis of the debtor, the patient may die on the operating

40. For the debate over whether the proper path to the rehabilitation of large firms is reorganization or sale, see *infra* Section I.C.2.

41. See references in *supra* note 10 and accompanying text.

42. *See, e.g.*, Bebchuk I, *supra* note 1, at 777–79; Bebchuk II, *supra* note 1, at 831–32.

43. *See* Roe, *supra* note 10, at 528–33, 536–48, 592; Bebchuk I, *supra* note 1, at 777–81, 789–90.

44. *See* Peter F. Coogan, *Confirmation of a Plan under the Bankruptcy Code*, 32 CASE W. RESERVE L. REV. 301, 311–13 (1982).

45. *Id.* at 311–12.

46. *Id.* at 314.

table while the lawyers are diagnosing."[47] Furthermore, empirical findings showed that the number of filings for bankruptcy were relatively low,[48] and that reorganizations destroyed firms' value,[49] albeit without deviating from the APP.[50] These results changed, at least at first, after the enactment of the Bankruptcy Code, as discussed below.

C. *Chapter 11: Structure, Operation and Costs*

1. *Structured Bargaining*

a. The Structure and Operation of Chapter 11 Bargaining

Since 1978, Chapter 11 has governed the rehabilitation of firms.[51] Chapter 11 allows managers to file for reorganization and commence a voluntary case without proving insolvency, and allows claimants to commence an involuntary case against a debtor with further requirements, including proving the firm's insolvency at its request.[52] At the commencement of a case, the bankruptcy court applies the automatic stay against all creditors.[53] It starts the collective period under the supervision of the specialized bankruptcy court—where all creditors

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47. Roe, *supra* note 10, at 530 n.7 (citing submitted reports and House hearings). *See generally* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 467–71 (1992).

48. *See infra* note 86 and accompanying text.

49. *See* Roe, *supra* note 10, at 530 n.7 (citing submitted reports and House hearings).

50. *See* Daniel Kim, Evolution of Debtor Rights 43 (Mar. 5, 2020) (unpublished paper) (on file with the BI Norwegian Business School).

51. Chapter 11 merged Chapters X, XI, and XII of the Bankruptcy Act of 1938. See Coogan, *supra* note 44, for the history and main principles of these chapters and their replacement by Chapter 11 of the Bankruptcy Code.

52. Section 301 allows the commencement of voluntary cases. 11 U.S.C. § 301 (2021). Section 303 allows the commencement of involuntary cases with further requirements. 11 U.S.C. § 303 (2021). For a discussion on the commencement of Chapter 11 voluntary and involuntary proceedings, see ADLER, BAIRD & JACKSON, *supra* note 35, at 66–79; 2 RICHARD LEVIN & HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶¶ 301–03 (16th ed. 2021). Findings showed that in the U.S., most bankruptcy cases are voluntary. *See ABI Reform*, *supra* note 16, at 20; Jason Kilborn & Adrian Walters, *Involuntary Bankruptcy as Debt Collection: Multi-Jurisdictional Lessons in Choosing the Right Tool for the Job*, 87 AM. BANKR. L.J. 123, 124 (2013). For further discussion of the Chapter 11 commencement stage, see *infra* Section III.D.

53. 11 U.S.C. § 362 (2021). For the automatic stay rules, scope, and exceptions, see ADLER, BAIRD & JACKSON, *supra* note 35, at 103–39; DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 195–210 (6th ed. 2014).

are party to the proceedings against the company and cannot realize assets individually—and enables the continuity that is crucial for rehabilitation.[54]

The law should then decide who should perform the managers' duties. Chapter 11's default rule gives those powers to the current management, referred to as the "debtor in possession" (DIP).[55] The court has the power to replace the managers for cause with a trustee.[56] A committee of creditors holding unsecured claims is appointed to consult with the management or, if appointed, the trustee.[57] In large reorganizations, an equity holders' committee and additional creditor committees are nominated to represent various interests in the firm.[58] Usually, the managers continue to perform their duties and prepare the reorganization plan.[59] In large cases, the board sometimes nominates a reorganization expert to lead the process, known as the "chief restructuring officer" (CRO).[60]

Chapter 11 leaves the problem of evaluation and the determination of a reorganization plan to negotiation between the firm and the claimant classes, under court supervision.[61]

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54. To preserve pre-bankruptcy substantive legal rights, the court may grant secured creditors relief from the stay "for cause, including the lack of adequate protection of an interest in property of such party in interest." 11 U.S.C. § 362(d) (2021). *See also* 11 U.S.C. § 361 (2021). For those criteria, see ADLER, BAIRD & JACKSON, *supra* note 35, at 411–30; BAIRD, *supra* note 53, at 203-207.

55. 11 U.S.C. § 1107 (2021).

56. 11 U.S.C. § 1104 (2021).

57. 11 U.S.C. §§ 1102–03 (2021). For the rules governing the creditor committees' operation, see, for example, Peter C. Blain & Diane Harrison O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 MARQ. L. REV. 581 (1990). The literature argues that the creditors' committees do not fulfill their goal of protecting investors. *See* Lynn M. LoPucki, *The Debtor in Full Control – Systems Failure Under Chapter 11 of the Bankruptcy Code*, 57 AM. BANKR. L.J. 99, 100 (1983).

58. *See* BAIRD, *supra* note 53, at 20.

59. *See* ADLER, BAIRD & JACKSON, *supra* note 35, at 679; BAIRD, *supra* note 53, at 11.

60. *See* BAIRD, *supra* note 53, at 215, 247. *See also* Anthony Horvat, *Defining the Role of the CRO: The Strategic and Tactical Benefits of a Seasoned Professional*, AM. BANKR. INST. J., Sept. 2005; Timothy W. Brink & James R. Irving, *Emerging Trends and Lingering Criticisms: A CRO Retention Update*, AM. BANKR. INST. J., Sept. 2013.

61. *See, e.g.*, Bebchuk I, *supra* note 1, at 779; Bebchuk II, *supra* note 1, at 832.

The role of Chapter 11 in this process is to provide rules that facilitate successful bargaining.

First, the law provides *agenda rules* that set the protocol for bargaining; for example, *exclusivity period rules* determining that "only the debtor may file a plan until after 120 days after the date of the order for relief" at the beginning of the case, and sixty additional days of exclusivity to gain acceptance.[62] The court may, for cause, extend the exclusivity period for filing a plan up to eighteen months and for acceptance up to twenty months, and after this period any party in interest may file a plan.[63] The suggested reorganization plan should include *adequate information* to enable claimants to make an informed judgment about it.[64] The debtor must submit a *disclosure statement* to the court, and the claimers' classes can vote on the approval of the plan only after the court has approved, after notice and hearing, that the disclosure statement contains adequate information.[65]

Second, the *voting rules* of Chapter 11 determine that "[a] class of claims has accepted a plan if such plan has been accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors . . . that have accepted or rejected such plan."[66]

Third, after the votes, the plan goes back to court for confirmation. The *confirmation rules* allow any party in interest to file an objection, and it requires that the court, after notice, hold a hearing on the matter.[67] To confirm the plan, the court has to verify that several requirements have been met, *inter alia*, that the plan has been proposed in good faith, and that "[c]onfirmation of the plan is not likely to be followed by the

62. 11 U.S.C.A. § 1121 (West 2005).

63. The court may also shorten the exclusivity period. *Id.*

64. 11 U.S.C.A. § 1125 (West 2005).

65. *See id.*

66. 11 U.S.C. § 1126(c). Not all classes have the right to vote. The impairment rule determines that a claimant class is considered as a class that accepts the plan, if the latter leaves unaltered its legal, equitable, and contractual rights. *See* 11 U.S.C. § 1124.

67. *See* 11 U.S.C. § 1128.

liquidation . . . of the debtor"—a criterion named *the feasibility test*.[68]

To complete Chapter 11's structured bargaining, the law empowers the court to enforce a plan, namely, *cramdown*.[69] The court may approve a plan even if a class rejects it when the following requirements are met, *inter alia*: all applicable requirements of the confirmation rules have been met, and "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan," and to enforce a plan, the court is required to hold valuation hearings to determine that the enforcement is fair.[70]

b. Structured Bargaining Costs and Deviations from the Absolute Priority Principle

i. *Ex-Post Effects of Chapter 11 Proceedings: The Destruction of Firms' Value*

The literature explored the complexity of the structured bargaining of Chapter 11, including its oversight litigation, and the way it destroyed firms' value.[71] Where a firm suffers from financial distress, many factors make this bargaining very

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68. 11 U.S.C. § 1129(a). For discussion of the confirmation rules, see ADLER, BAIRD & JACKSON, *supra* note 35, at 678–87, 732–44; BAIRD, *supra* note 53, at 258–60, 264–76; 7 LEVIN & SOMMER, *supra* note 52, ¶ 1129.02.

69. *See* 11 U.S.C. § 1129(b).

70. 11 U.S.C. § 1129(b). For a discussion of the requirements for confirming a plan even if a class rejects it, see, for example, ADLER, BAIRD & JACKSON, *supra* note 35, at 707–31; BAIRD, *supra* note 53, at 260–64; 7 LEVIN & SOMMER, *supra* note 52, ¶ 1129.03. Cramdown is designed to complete the structured bargaining by posing an expensive threat to claimant classes that might use holdup powers to delay confirmation. *See* Walter W. Miller, Jr., *Bankruptcy Code Cramdown Under Chapter 11: New Threat to Shareholder Interests*, 62 B.U. L. REV. 1059 (1982).

71. *See, e.g.*, Baird I, *supra* note 1; JACKSON, *supra* note 34; Bebchuk I, *supra* note 1; Adler, *supra* note 47; Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 61 J. FIN. 1253 (2006); Baird, Casey & Picker, *supra* note 33; Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 821–27 (2017); Kenneth M. Ayotte & Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 166 U. PA. L. REV. 1819 (2018). For analysis and research of financial distress and bankruptcy costs, see Michelle J. White, *Bankruptcy Law, in* 2 HANDBOOK OF LAW AND ECONOMICS 1013 (A. Mitchell Polinsky & Steven Shavell eds., 2007); EDWARD I. ALTMAN, EDITH HOTCHKISS & WEI WANG, CORPORATE FINANCIAL DISTRESS, RE-

difficult, including the uncertainty about the business parameters relevant to the negotiation's outcome, the private and unverifiable nature of some of the required information, the number of parties, the incentives for their strategic behavior, the inability of pre-bankruptcy contracts to predict and solve a very wide range of possible scenarios, and the interconnections between claimants' contracts.[72] Under Chapter 11 proceedings, costly and lengthy valuation disputes require judges to choose between opposing expert testimonies using vague criteria (e.g., calculating the cash flow value) to determine the claimants' rights (e.g., the amount each creditor is owed and its priority, or whether the firm provides adequate protection to collaterals) and complex valuation hearings to determine whether the plan meets enforcement requirements (cramdown).[73]

Findings show that Chapter 11 proceedings cause high direct costs and severe indirect costs that destroy the firm's value.[74] First, findings indicated the direct costs of bankruptcy—mainly legal and other expert fees—can reach tens of millions of dollars for public companies.[75] Second, research

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STRUCTURING, AND BANKRUPTCY: ANALYZE LEVERAGED FINANCE, DISTRESSED DEBT, AND BANKRUPTCY (4th ed. 2019).

72. *See, e.g.*, Adler, *supra* note 47, at 464–67; 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, 166 (1989); Baird II, *supra* note 1, at 638; Kenneth M. Ayotte, Anthony J. Casey & David A. Skeel, Jr., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255 (2017); Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017) [hereinafter Baird, *Bankruptcy's Quiet Revolution*]; Casey, *supra* note 35, at 1730.

73. *See, e.g.*, Ayotte & Morrison, *supra* note 71; Kenneth M. Ayotte, *Disagreement and Capital Structure Complexity*, Working Paper (2019), https://ssrn.com/abstract=3276779.

74. For a review of empirical works on bankruptcy's direct and indirect costs, see White, *supra* note 71, at 1040–41; Bris, Welch & Zhu, *supra* note 71; Stephen J. Lubben, *What We "Know" About Chapter 11 Cost Is Wrong*, 17 FORDHAM J. CORP. & FIN. L. 141 (2012); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Survival*, 62 UCLA L. REV. 970 (2015).

75. *See, e.g.*, Edward I. Altman, *A Further Empirical Investigation of The Bankruptcy Cost Question*, 39 J. FIN. 1067 (1984); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 286 (1990) (finding that the direct costs of bankruptcy averaged 3.1% of the combined value of debt plus equity); 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). Bris, Welch and Zhu showed that measures of costs were sensitive to different estimation methods. The

showed higher indirect costs (albeit harder to estimate): financial distress costs stemming, among other things, from lost sales volume, forgone business opportunities in obtaining new projects, and financial uncertainties.[76] Weiss, for example, found that indirect costs could be twenty times higher than direct costs in some cases.[77] Bris, Welch, and Zhu reported that firms exited Chapter 11 with asset values lower by a median of 13% than upon entry into bankruptcy (and for Chapter 7 bankruptcies, 62%).[78] They reported an average time spent in bankruptcy of two years (for both Chapter 7 and Chapter 11 bankruptcies).[79] They also found far better recovery rates under Chapter 11—for example, unsecured creditors received a mean recovery rate of 52% under Chapter 11 but just 1% under Chapter 7.[80]

Dou, Taylor, Wang and Wang explored Chapter 11 bargaining and focused on the effects of the conflict of interests between the creditors and the asymmetric information between them on its outcome.[81] They estimated that, without conflict of interests and asymmetric information, the average total payout to secured and unsecured creditors would increase by 29% and 11% of the firm value, respectively.[82] They found that these frictions delayed bargaining, thereby destroying value.[83]

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expected direct costs of a case, for example, could range between 2%–20% of fees over assets. They also claimed that bankruptcy costs are high in some cases and modest in others. *See* Bris, Welch & Zhu, *supra* note 71, at 1301.

76. *See, e.g.*, Weiss, *supra* note 75; Edith Shwalb Hotchkiss, *Postbankruptcy Performance and Management Turnover*, 50 J. Fin. 3 (1995); Bris, Welch & Zhu, *supra* note 71.

77. *See* Weiss, *supra* note 75.

78. Bris, Welch & Zhu, *supra* note 71, at 1262–70.

79. *See id.* at 1270–78.

80. *See id.* at 1287–98.

81. *See* Winston Wei Dou, Lucian A. Taylor, Wei Wang & Wenyu Wang, Dissecting Bankruptcy Frictions, Working Paper (2020), https://ssrn.com/abstract=3383837.

82. *Id.*

83. *See id.* They estimated the effects of these frictions (conflict of interests and asymmetric information) in a model using data on 311 Chapter 11 filings (prepackaged and traditional) by large, public, non-financial U.S. firms from 1996 to 2014. They found that excess liquidation and excess continuation were minor problems, quantitatively speaking. *See id.*

The success of the 1978 reform was a matter of controversy.[84] Nevertheless, most research showed that the two arrangements were slow and costly.[85] The literature also showed improvements that occurred after the 1978 reform such as an increase in the number of bankruptcy filings,[86] reorganization confirmation rates, and firms' survival times in Chapter 11.[87]

ii. *Ex-ante Effects of Deviations from the Absolute Priority Principle*

Empirical findings showed that Chapter 11 proceedings induced significant deviations from the APP where shareholders recovered from the firm reorganization while unsecured creditors were not paid in full.[88] Chapter X did not allow

84. *See, e.g.*, Elizabeth Warren & Jay L. Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603 (2009); Bris, Welch & Zhu, *supra* note 71.

85. *See, e.g.*, Roe, *supra* note 10, at 530; Adler, *supra* note 47, at 463–71.

86. Only a few studies have directly examined changes between the pre- and post-reform periods. The number of bankruptcy filing may serve as another indicator for indirect bankruptcy costs, and findings show that after the reform became effective, this number dramatically increased. *See, e.g.*, William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J.L. & ECON. 139, 144–47 (1986). Scholars have suggested different reasons for this phenomenon, such as changes in interest rates or in the structure of the law. *See id.* Among the latter, Chapter 11's empowering of the current management, especially to control the bargaining, may explain this phenomenon.

87. Based on large samples of Chapter 11 cases filed in 1994 and 2002, Warren and Westbrook found, for example, that cases survived a year without being dismissed and with the firm managing to confirm a plan 76.5% of the time in 1994 and 82.5% of the time in 2002. Warren & Westbrook, *supra* note 84, at 612–23. They also found that the time-to-resolution for cases was 329 and 327 days, respectively (for large firms, it was three to four months longer, respectively). *Id.* at 623–34. Warren and Westbrook noted that the time-to-resolution for Chapter 11 cases was approximately half the time-to-resolution found by Bris, Welch & Zhu since the latter's sample included more classes of cases. *See id.* at 614.

88. *See* Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, *supra* note 33, at 445. For a review of empirical works on the frequency and size of deviations from the APP, see White, *supra* note 71, at 1041–43; Daniel Kim, *supra* note 50. *See, e.g.*, Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989); Weiss, *supra* note 75; Allan C. Eberhart, William T. Moore & Rodney L. Roenfeldt, *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 747 (1990); Brian L. Betker, *Management's Incentives, Eq-*

deviation from the APP, and in the era of Chapter 11 structured bargaining, this phenomenon emerged.[89]

The literature has shown how the structured bargaining of Chapter 11 results in the deviations from the APP.[90] Bebchuk and Chang identified three factors that may give equity holders the power to extract value from debtholders under Chapter 11.[91] First, if the parties failed to reach an agreement, the supervising court would ultimately convert the proceedings into a Chapter 7 sale of assets that would likely involve a loss of value.[92] Second, if no agreement was reached in a timely fashion, the company might incur financial distress costs that could decrease the pie available for distribution among the creditors.[93] Third, the shareholders that agreed to settlement had to waive their option to receive a higher value in the future if the company's probability of success and higher value materialized.[94] Therefore, equity holders were able to obtain value even before creditors were paid in full in return for their consent.

The literature discussed three additional factors that allow equity holders to extract value under the existing rules.[95] Fourth, the reform gives managers, who may have been hired by and may be allied with equity holders, a minimum of the first four months of bargaining to develop the first reorganization plan,[96] which presents creditors with a take-it-or-leave-it

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uity's Bargaining Power, and Deviations from Absolute Priority in Chapter 11 Bankruptcies, 68 J. BUS. 161 (1995).

89. *See* Kim, *supra* note 50, at 22.

90. *See* Lucian A. Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization,* 8 J.L. ECON. & ORG. 253, 255 (1992); *see also* Bebchuk II, *supra* note 1, at 832–33.

91. *See* Bebchuk & Chang, *supra* note 90; *see also* Bebchuk II, *supra* note 1, at 832–33.

92. *See* Bebchuk & Chang, *supra* note 90, at 256; *see also* Bebchuk II, *supra* note 1, at 832–33.

93. *See* Bebchuk & Chang, *supra* note 90; *see also* Bebchuk II, *supra* note 1, at 832–33.

94. *See* Bebchuk & Chang, *supra* note 90, at 255–56; *see also* Bebchuk II, *supra* note 1, at 832–33.

95. *See, e.g.*, White, *supra* note 71, at 1021–22; Dirk Hackbarth, Rainer Haselmann & David Schoenherr, *Financial Distress, Stock Returns, and the 1978 Bankruptcy Reform Act*, 28 REV. FIN. STUD. 1810 (2015).

96. According to the exclusivity period rules, the managers have four months to file a plan, which the court may extend, for cause, up to eighteen months. *See supra* notes 62–63 and accompanying text.

choice. Fifth, firms can file for Chapter 11 when still solvent, and managers can use this power to extract value from creditors. Lastly, the reform gives management the power to enforce the reorganization plan by a valuation hearing or sale of the firm by the court. The latter has become significant after 2000 as a source of inefficiencies, as discussed next.

2. *Reorganization Sales as a Going Concern and the Age of Institutional Investors*

a. Institutional Investors' Powers and "Fire Sales"

The literature found that after 2000, there was an increase in senior creditors' control in Chapter 11 cases, where secured creditors increased their control by means of loan contracts and market practices.[97] For example, they could add a clause to funding agreements entitling them to appoint a CRO.[98] They could also gain control over the preparation of the reorganization plan and sale through their control over post-petition financing. A DIP lending agreement under Chapter 11 could even provide that the debtor had to propose a reorganization plan with the DIP lenders' consent by a specific deadline or to arrange for a sale of some or all of the debtor's assets

97. *See, e.g.*, David A. Skeel, Jr., *Doctrines and Markets: Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003) [hereinafter Skeel, *Doctrines and Markets*]; Baird & Rasmussen, *supra* note 7, at 785; LoPucki, *supra* note 7, at 660; Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, AM. BANKR. INST. J. 12 (Sep. 2003); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1217 (2006) [hereinafter Baird & Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*]; Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 666–77 (2010); Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29 J.L. ECON. & ORG. 461 (2013); William W. Bratton & David A. Skeel, Jr., *Foreword: Bankruptcy's New and Old Frontiers*, 166 U. PA. L. REV. 1571, 1580–83 (2018) (arguing that the current phase might be considered as a new third era, with more distressed debt professionals joining DIP lenders as major players and more types of contracting giving DIP lenders incentives for both cooperative and uncooperative behavior); Robert K. Rasmussen, *Taking Control Rights Seriously*, 166 U. PA. L. REV. 1749, 1755 (2018); Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. (forthcoming 2021), https://ssrn.com/abstract=3611350.

98. *See, e.g.*, Baird & Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, *supra* note 97, at 1233–34. For the CRO's role in Chapter 11 proceedings, see references in *supra* note 60 and accompanying text.

by a specific date—otherwise, the loan would terminate or would be offered under worse terms.[99]

In *The End of Bankruptcy*, Baird and Rasmussen argued that modern companies did not have a special going-concern value that was higher than the value of their assets,[100] that markets today could shift control rights in distressed firms without collective bankruptcy proceedings,[101] and that going-concern sales were common practice, especially in the reorganization of large firms.[102] This act of selling is allowed under bankruptcy law even before the approval of a plan, and the buyer may purchase the firm free of past debt.[103] In other studies, Baird suggested that this common solution should govern the rehabilitation of large firms.[104]

The literature expressed doubt regarding sales under Chapter 11 reorganization proceedings, viewing them as "fire sales" conducted in a hurry and under terms that did not benefit all creditors.[105] Based on empirical research, LoPucki

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99. *See, e.g.*, Baird & Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, *supra* note 97, at 1236–42. Ayotte and Ellias defined cases where managements agree to transfer control over the bankruptcy process to the company's creditors at the beginning of Chapter 11 in exchange for compensation as a "bankruptcy process sale." *See* Ayotte & Ellias, *supra* note 97, at 3. They identified two types of process sales: plan protection—a compensation scheme under the DIP lender's agreement that gives incentives to a specific plan; and entitlement protection, where the DIP lender's agreement protects their pre-bankruptcy rights against litigation where the rights are claimed to be invalid, e.g., by a fraudulent transfer action. They found that the proportion of DIP loans in their sample that required managements to implement a specific transaction increased from an average of 10% in 1995–2000 to 57% in 2010–2015. *Id.* at 6.

100. *See* Baird & Rasmussen, *supra* note 7, at 758–77.

101. *See id.* at 778–85.

102. *See id.* at 786–88. For a discussion of firms' going-concern sale in reorganization, see Robert K. Rasmussen & Douglas G. Baird, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); ADLER, BAIRD & JACKSON, *supra* note 35, at 667–78; BAIRD, *supra* note 53, at 235–38; Lynn M. LoPucki, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 8–11 (2007).

103. *See* 11 U.S.C. § 363(b) and its interpretation in *In re Lionel Corp.*, 722 F.2d 1063, 1066 (2d Cir. 1983).

104. As mentioned above, Baird suggested auction as a method of dealing with insolvency of public companies. See *supra* Introduction A. For Baird's auction method, see *infra* Section I.D.3.

105. *See, e.g.*, LoPucki, *supra* note 7; LoPucki, *supra* note 102; Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009); Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy Law as a*

showed that more than half of large-firm bankruptcies ended in reorganization rather than sale.[106] Moreover, in modern firms, relations between employees, their knowhow, and relations with others outside the firm create its going-concern value.[107] Furthermore, sales are often not in the creditors' best interest.[108] LoPucki examined insolvent firm's recovery ratios, and found that debtors who reorganize have substantially higher recovery ratios (75%) than debtors who sell (29%).[109] He also found that on average, sales occurred before the approval of reorganization plans (sales and reorganizations, 223 and 314 days after filing, respectively).[110] In the sale cases he studied, however, confirmation occurred on average 611 days after filing (compared to 314 days in reorganization cases).[111]

The literature discussed reasons why institutional investors' control and DIP lending contracts and tactics might infringe on bankruptcy outcomes.[112] LoPucki argued that "fire sales" might be the outcome of institutional investors' powers.[113] For example, investment banks that lead the firm's transactions have incentives to underestimate the firm's value (underprice),[114] and the DIP lenders who receive a high interest rate at the beginning of the proceedings might later act to

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Liquidity Provider, 80 U. CHI. L. REV. 1557 (2013); Charles Jordan Tabb, *What's Wrong with Chapter 11?* (U. Ill. C.L. Legal Stud. Research Paper No. 19-15, 2019), https://ssrn.com/abstract=3352137.

106. *See* LoPucki, *supra* note 7, at 646, 660–65.

107. *See id.* at 651–59.

108. *See id.* at 666–70.

109. *See* LoPucki, *supra* note 102, at 22–25.

110. *See id.*

111. *See id.* at 22. Bratton and Skeel argued, however, that during the new era of institutional investors' powers, bankruptcy proceedings became quicker, as more firms avoided the traditional reorganization either by selling all of their assets or by seeking judicial approval of a prepackaged bankruptcy. *See* Bratton & Skeel, *supra* note 97, at 1581.

112. *See, e.g.*, LoPucki, *supra* note 102, at 22; Skeel, *Doctrines and Markets*, *supra* note 97; Warren & Westbrook, *supra* note 97; Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011); Adler et al., *supra* note 97; Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014); Oscar Couwenberg & Stephen J. Lubben, *Private Benefits Without Control? Modern Chapter 11 and the Market for Corporate Control*, 13 BROOK J. CORP. FIN. & COM. L. 145 (2018); Ayotte & Ellias, *supra* note 97.

113. *See* LoPucki, *supra* note 102 at 4.

114. *See id.* at 34–36.

guarantee their return using their control powers or sometimes even purchase the firm.[115] He also found that managers sometimes benefit from sales by joining the buyer.[116] Ayotte and Ellias claimed that the DIP lenders' control might lead to inefficient sales or to ending the case too early where the seniors' rights appear to be particularly at risk; for example, with the presence of a second lien loan or a possible fraudulent transfer action against the DIP lenders.[117] Ayotte and Skeel argued that a debt-overhang problem occurs when creditors are secured by all the firm's assets and new credit is necessary and efficient.[118] Taking into account that in a bad state, the secured creditors are paid first, potential new creditors will ask for a high interest rate. When the risk of bankruptcy becomes high enough, the new project becomes unfeasible. In this dire situation, the secured creditors have incentives to initiate a "fire sale" (and this phenomenon justifies formal reorganization).[119]

b. Bankruptcy Costs and Deviations from the Absolute Priority Principle in the New Era

Based on research and testimonies describing the costs and loss of control associated with Chapter 11, the American Bankruptcy Institute (ABI) Reform claimed in 2014 that "anecdotal evidence suggests that Chapter 11 has become too expensive."[120] Among the evidence were findings showing that

115. *See id.* at 36–37. For the literature discussing DIP lenders' incentives to initiate sales, see, for example, Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 173 (2005); Kenneth Ayotte & David A. Skeel, Jr., *Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425 (2006); Baird & Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, *supra* note 97, at 1249–50; Jacoby & Janger, *supra* note 112.

116. *See* LoPucki, *supra* note 102, at 32–34.

117. Ayotte & Ellias, *supra* note 97 (finding greater dispute over the DIP lenders' control to be a factor in the inefficiency of the DIP lenders' control, in cases where the seniors' rights appear to be particularly at risk).

118. *Id.*

119. Ayotte & Skeel, *supra* note 105, at 1571–72. They also claimed that a bank that has information superiority might use it as an anti-competition tool that enables it to charge a higher interest rate or as a tool to promote proposing to purchase the debtor's assets at a "fire-sale" price. *Id.* at 1579–89.

120. *ABI Reform*, *supra* note 16, at 12.

companies waited too long to file for bankruptcy.[121] Adler, Capkun, and Weiss showed that at the time of filing for bankruptcy, debtors who filed after 2001 were in significantly worse financial conditions than debtors who filed prior to 2000.[122] They argued that fear of secured creditors caused managers to delay filing.[123] Debtors who filed after 2001 incurred significantly higher indirect costs, meaning that delays destroyed value.[124] Furthermore, testimonies on the allocation of value in Chapter 11 cases showed that only little was left, if any, to junior creditors.[125]

As mentioned above, research showed that debtors who reorganize have substantially higher recovery ratios than debtors who sell and that both proceedings are lengthy.[126] The finding showed a decreased shareholder recovery rate in the new era.[127] Kim found that after the shareholders' recovery rate had increased from zero to its highest after the 1978 reform, it gradually decreased until it became almost zero from 2005 to 2018.[128] Zero shareholder recovery apparently reflects preserving the APP. If little is left for unsecured creditors, however, this outcome cannot be seen as consistent with preserving junior classes' rights.

In sum, it seems that the hybrid system of traditional bargaining and litigation with more institutional investors' powers and ("fire") sales contributes to high bankruptcy costs, leaving almost nothing to unsecured creditors, but allegedly without deviating from the APP. This means a withdrawal back to indicators reminiscent of the pre-1978 reform era.

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121. *See id.* at 12, 20.
122. Adler et al., *supra* note 97.
123. *Id.*
124. *Id.*
125. *See, e.g.*, *ABI Reform*, *supra* note 16, at 207; Tabb, *supra* note 105, at 14–15. For a discussion of ABI's suggestion to grant junior creditors a redemption option value as a correction, see *infra* Section I.E.1.
126. *See supra* notes 106–11 and accompanying text. *See also* Shai Bernstein, Emanuele Colonnelli & Benjamin Iverson, *Asset Allocation in Bankruptcy*, 74 J. FIN. 5 (2019).
127. *See* Sreedhar T. Bharath, Venky Panchapagesan & Ingrid M. Werner, *The Changing Nature of Chapter 11* (Fisher C. of Bus., Working Paper No. 2008-03-003, 2010), https://ssrn.com/abstract=1102366. *See generally* Hackbarth, Haselmann & Schoenherr, *supra* note 95; Kim, *supra* note 50, at 1, 19.
128. Kim, *supra* note 50, at 3.

D. *Alternative Mechanisms*

1. *Roe's Partial Sale*

Roe suggested revealing the firm's value by selling a fraction of the reorganized company's shares, e.g., 10%, in the stock market, and then using the revealed firm's value to create a reorganization plan that meets the APP.[129] The literature indicated, however, that selling a small part of the company gives incentives for manipulations that impair the parties' ability to determine the firm's value.[130] The other alternative mechanisms presented next avoid this problem by selling *all* of the company's shares.

2. *Bebchuk's Options Model*

Bebchuk proposed an options mechanism for bankruptcy reorganization by selling the company's ownership to its claimants, based on the transformation of the original claims against the firm into options that allow junior classes to buy out all of the senior classes at the price of the latter's claims.[131] He showed that the mechanism prevents deviations from the APP and from the claimants' rights, regardless of the materialization of the firm's value.[132] First, if the firm's value exceeds the total amount of debt, the equity holders exercise their options and gain the residual firm's value after paying the exact amount of debt to the creditors. Second, if the firm's value is less than the total amount of debt but more than the secured debt, the equity holders do not exercise their options, which is consistent with their original right. In this case, the unsecured creditors exercise their options and gain the firm's value after paying to secured creditors, which is the exact value of both classes' rights. Finally, if the firm's value is less than the total amount of the secured debt, only the secured creditors exercise their options and gain the firm's value, which is their right in this case.[133] Bebchuk argued that this mechanism guaranteed a perfect assessment of the minimum value of partici-

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129. Roe, *supra* note 10, at 530.

130. *See, e.g.*, Adler & Ayres, *supra* note 10, at 144.

131. *See* Bebchuk I, *supra* note 1, at 781–88; Bebchuk II, *supra* note 1, at 830.

132. *See* Bebchuk I, *supra* note 1, at 777; Bebchuk II, *supra* note 1, at 833.

133. *See* Bebchuk I, *supra* note 1, at 787–92; Bebchuk II, *supra* note 1, at 838–39. Bebchuk also showed that the options model could be applied in

pants' entitlements.[134] Moreover, the options of public companies could be traded in the stock market, which is able to provide efficient evaluation and liquidation.[135]

3. *Baird's Auction Method*

Baird suggested a market-based technique to replace Chapter 11 with an actual sale of the firm as a going-concern or piecemeal, free from debt, shortly after filing for bankruptcy.[136] Baird argued that this technique separates the sale of the firm to determine value from the allocation of the proceeds to the claimants and achieves two goals.[137] First, this leaves the decision whether to reorganize or liquidate the firm to the new owner, who is optimally positioned to maximize the firm's value. Second, the proceeds will be divided among the claimants after the valuation by an auction according to the APP.

4. *Aghion, Hart, and Moore's Model*

Aghion, Hart, and Moore's model further developed Bebchuk's options model by adding a second stage of decision making. They argued that this preserves the notion of maximizing the firm's value without deviations from the APP, while achieving another goal of bankruptcy: making optimal decisions about what to do with the company's assets.[138] Under

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the general case of classifying the claimants to any number of classes. *See* Bebchuk I, *supra* note 1, at 799–801; Bebchuk II, *supra* note 1, at 836.

134. Bebchuk I, *supra* note 1, at 789; *see* Bebchuk II, *supra* note 1, at 838–39.

135. *See* Bebchuk I, *supra* note 1, at 793–96; *see also* Bebchuk II, *supra* note 1, at 838–40 (describing the ability of participants to sell their rights in the market and stating that market pricing of these rights is an important additional source of information).

136. *See* Baird I, *supra* note 1, at 145; *see also* Baird II, *supra* note 1, at 634–35. For other discussions on the desirability of auctions over Chapter 11 reorganization, see Thomas H. Jackson, *Comment on Baird, "Revisiting Auctions in Chapter 11,"* 36 J.L. & ECON. 655, 662–64 (1993), and White, *supra* note 71, at 1035–37.

137. *See* Baird II, *supra* note 1, at 638–39; *see also* White, *supra* note 71, at 1035.

138. *See* Aghion, Hart & Moore II, *supra* note 20, at 852–53, 865–66; *see also* Aghion, Hart & Moore I, *supra* note 20, at 532–33, 537 (stating that the proposal attempts to maximize the firm's ex-post value while leaving discretion in the hands of claimants).

their mechanism, noncash and cash bids over the new rehabilitated firm are submitted before and voted after the exercise of the options.[139] In the voting stage, there is only one class of homogenous new equity holders, and claimants who become the new owners are expected to vote without a conflict of interest and accept the optimal plans for the firm.[140]

5. *Adler and Ayres' Model*

Adler and Ayres proposed a dilution mechanism that grants the senior creditors all the shares, allowing them to rehabilitate the firm.[141] The mechanism, which is based on Bebchuk's options model and preserves its advantages, allows junior classes to buy new shares until there is no excess demand for the stocks at a price that would implement the APP (a fixed price that, if paid by all juniors, will cover the seniors' debt). When the reorganized firm is worth more than the seniors' debt, the juniors are expected to execute their right for new shares in the reorganized firm at the cost of the seniors' debt and hold the firm's residual value while the seniors' share would be worth the value of the debt. The junior classes do not have to buy all the shares, which gives liquidity advantages as well as the advantages of leaving part of the company in the hands of the secured creditors.[142]

E. *Suggested Reform and Workouts*

1. *The ABI Reform*

The 2014 ABI Reform document[143] includes 400 pages of discussions and recommendations on multiple aspects of Chapter 11 proceedings. The ABI Commission to Study the Reform of Chapter 11 found that Chapter 11 cases generated little, if any, value to junior creditors.[144] Accordingly, it proposed that in Chapter 11 reorganization plans and sales, a jun-

139. *See* Aghion, Hart & Moore I, *supra* note 20, at 524, 533, 536; *see also* Aghion, Hart & Moore II, *supra* note 20, at 862–63 (describing the proposal's bidding and voting timeline).

140. *See* Aghion, Hart & Moore I, *supra* note 20, at 524, 537; Aghion, Hart & Moore II, *supra* note 20, at 861.

141. Adler & Ayres, *supra* note 10, at 86–87.

142. *Id.* at 86, 141–42.

143. *ABI Reform*, *supra* note 16.

144. *Id.* at 207–24.

ior class that might otherwise be permanently cut off would receive a *redemption option value*, reflecting the possibility that in the three years following the bankruptcy petition, the firm's value might increase and cover the debt to the secured creditors.[145]

2. *Non-Bankruptcy Workouts*

In a state of financial distress, managers can offer a pre-bankruptcy reorganization plan, or *workout*. On its face, a workout has the potential of saving bankruptcy costs and beginning rehabilitation when it is still possible. Findings show that most large companies experiencing financial difficulties negotiate for workouts, which are sometimes approved by the claimants but involve deviations from the APP. When workouts fail, managers usually continue bargaining after filing for Chapter 11, using the workout proposal as a Chapter 11 reorganization plan ("pre-pack"), with higher rates of success.[146] The literature discusses two main reasons for workouts' failures.[147] First, bondholders' approval of a workout should be unanimous, meaning that they have individual veto power they might use for holdup.[148] Second, bondholders face asymmetric information problems and cannot differentiate between real financial and strategic difficulties, and therefore fear strategic default by the managers.[149]

The literature acknowledged the potential of violating bondholders' rights by workouts, including by coercive offers, as well as the potential of strategic behavior by both managers and bondholders.[150] To avoid infringements of creditors' rights, the Trust Indenture Act of 1939 prohibits majority-vote amendments of the payment terms of bonds, and enables

145. *Id.* at 207–11, 218–24. For criticism on the ABI proposal, see Barry E. Adler & George Triantis, *Debt Priority and Options in Bankruptcy: A Policy Intervention*, 91 AM. BANKR. L.J. 563, 589–91 (2017).

146. *See* White, *supra* note 71, at 1042–43.

147. *See id.* at 1023–24; *see also* Ayotte & Skeel, *supra* note 105, at 1579–89.

148. *See* White, *supra* note 71, at 1023–24.

149. *See id.* at 1023–24; *see also* Ayotte & Skeel, *supra* note 105, at 1581–83 (presenting the bank's information superiority as causing an adverse-selection problem whereby the bank denies a loan considered by new investors, suggesting that this failure justifies formal reorganization).

150. *See, e.g.*, White, *supra* note 71, at 1023–24, 1042–43; William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 UNIV. PA. L. REV. 1597, 1600, 1604–11, 1627–34 (2018).

workouts by unanimous contractual amendment.[151] Nevertheless, there are calls for revision.[152] For example, Bratton and Levitin argued that, due to temporary lack of financing in 2008, distressed borrowers turned to exchange offers with large institutional investors as a lawful means of workout, and that this practice persists.[153] They also argued that even though coercive tactics are more salient today than ever, this is not true of all cases, and that a good faith constraint on majority bondholder voting power together with the good faith duty's limited constraints on bond issuers would be a proper basis for amendments.[154]

II.
THE GORDIAN KNOT THEORY OF BANKRUPTCY PROCEEDINGS

A. *Allocation Problems and the Costs of Chapter 11's Structured Bargaining and Hearings in the Allocation and Reallocation Stages*

1. *Allocation Problems of Bankruptcy Law*

I turn now to the reorganization proceedings' AS and show that it is a vast source of litigation. After the commencement of a Chapter 11 case, the firm has to perform the allocation process that determines the equity holders and creditors' original rights, including to *schedule claims*, and to send notices to them.[155] A claimant who is not listed or whose claim is

151. For the protections that the law provides bondholders, see, for example, Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040 (2002). Kahan justified the main arrangements related to the amendment of principal economic terms in the bonds. *Id.* at 1068–69.

152. *See, e.g.*, Mark J. Roe, *The Trust Indenture Act of 1939 in Congress and the Courts in 2016: Bringing the SEC to the* Table, 129 HARV. L. REV. F. 360 (2016); Bratton & Levitin, *supra* note 150; Carlos Berdejo, *Revisiting the Voting Prohibition in Bond Workouts*, 89 TUL. L. REV. 541 (2015); David S. Stevenson, *Grab the Fire Extinguisher: Comparing UK Schemes of Arrangement to U.S. Corporate Bankruptcy after Jevic*, 68 CLEV. ST. L. REV. 73 (2019); Aurelio Gurrea-Martínez, *The Future of Reorganization Procedures in the Era of Pre-Insolvency Law*, 21 EUR. BUS. ORG. L. REV. 829 (2020).

153. Bratton & Levitin, *supra* note 150, at 1601, 1634–35.

154. *Id.* at 1601–04, 1665–74.

155. 11 U.S.C. §§ 501, 1111(a); FED. R. BANKR. P. 3003(c)(2). For a discussion of the reorganization AS under Chapter 11 proceedings, see, for example, ADLER, BAIRD & JACKSON, *supra* note 35, at 141–89; BAIRD, *supra* note 53, at 76–77; 7 LEVIN & SOMMER, *supra* note 52, ¶ 1111.

scheduled as disputed, contingent, or unliquidated, must file a proof of claim to exercise his right. Otherwise, his claim would be discharged by the approval of the plan. Any party in interest may file an objection to a filed proof of claim, and otherwise, it is deemed allowed. Then, the court holds hearings to determine the unresolved claims, after notice.[156] Questions of claim recognition and assessment,[157] fraudulent transfer and voidable preferences actions,[158] determination of tort claims,[159] objections to roll-ups—payments to suppliers for post-petition debt[160]—and rejection or assumption of executory contracts can all be sources of litigation.[161]

Another task of the AS is claim *classification*[162]—dividing the claimants into classes according to the APP.[163] The law al-

156. 11 U.S.C. §§ 502(a), 502(b); FED. R. BANKR. P. 3007.

157. *See, e.g.*, BARRY E. ADLER, ANTHONY J. CASEY & EDWARD R. MORRISON, BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 361–469 (5th ed. 2020); BAIRD, *supra* note 53, at 76–92. For the complexity of the claims' valuation hearings, see Ayotte & Morrison, *supra* note 71, at 1824–41; Ayotte, *supra* note 73.

158. *See, e.g.*, ADLER, CASEY & MORRISON, *supra* note 157, at 309–99; BAIRD, *supra* note 53, at 140–94.

159. *See, e.g.*, BAIRD, *supra* note 53, at 81–83; George W. Kuney, *Bankruptcy and Recovery of Tort Damages*, 71 TENN. L. REV. 81 (2003).

160. *See, e.g.*, Richard M. Hynes & Steven D. Walt, *Inequality and Equity in Bankruptcy Reorganization*, 66 KAN. L. REV. 875 (2018).

161. *See, e.g.*, ADLER, CASEY & MORRISON, *supra* note 157, at 223–74; BAIRD, *supra* note 53, at 112–39.

162. 11 U.S.C. § 1122. For Chapter 11 classification rules, their operation and the phenomenon of managers using classification rules strategically to manipulate the confirmation of a plan, see, for example, ADLER, CASEY & MORRISON, *supra* note 157, at 687–97; BAIRD, *supra* note 53, at 249–54; 7 LEVIN & SOMMER, *supra* note 52, ¶ 1122; *ABI Reform, supra* note 16, at 260.

163. For the APP and its application in Chapter 11, see, for example, ADLER, BAIRD & JACKSON, *supra* note 35, at 707–32; BAIRD, *supra* note 53, at 57–75, 260–67; 4 LEVIN & SOMMER, *supra* note 52, ¶ 507. *See also* Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279 (1997); Baird & Bernstein, *supra* note 10; Adler & Triantis, *supra* note 145.

In 2017, the U.S. Supreme Court delivered an important decision determining that a bankruptcy court should not approve a structured dismissal of reorganization proceedings that does not follow the APP without the affected creditors' consent. *See Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 978 (2017). For a discussion of the meaning and application of the APP advanced by this ruling, see, for example, Jonathan C. Lipson, *The Secret Life* lows pooling claims or interests in a single class if they are substantially similar.[164] Usually, if secured creditors are secured by a different collateral or have priority over others, they do not meet this criterion. For unsecured creditors, this criterion is vague and can be manipulated by the debtor who seeks to secure the approval of a certain plan. The classification of claims should be revealed as part of the disclosure statement[165] and it is subject to objections and hearings.[166]

Another source of litigation is the valuation of secured creditors' debt that is limited to the collateral's value—the law instructs the court to hold hearings on the matter and estimate it.[167] The same applies to litigation over secured creditors' demand to free assets for cause, including the lack of adequate protection of an interest in property.[168]

2. *The Costs of Chapter 11's Structured Bargaining and Hearings in the Allocation and Reallocation Stages*

The structured bargaining and the hearings (to oversee the negotiation and protect claimants' rights) that the law requires at the AS and the RS come with the direct and indirect

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of Priority: Corporate Reorganization after Jevic, 93 WASH. L. REV. 631 (2018); Hynes & Walt, *supra* note 160.

For suggestions to revise the APP's meaning, see, for example, Baird, *Bankruptcy's Quiet Revolution*, *supra* note 71 (Baird claimed that the costs of applying the current "absolute priority" system are too high, as the starting point of absolute priority with bargaining causes distortions, and suggested a system of "relative priority" whereby the juniors receive rights to execute their share in the firm after its rehabilitation).

164. 11 U.S.C. § 1122.

165. 11 U.S.C. § 1123(a).

166. For court rulings on claimants' objections to classification under Chapter 11 reorganization plans, see, for example, ADLER, BAIRD & JACKSON, *supra* note 35, at 687–97; BAIRD, *supra* note 53, at 249–54; 7 LEVIN & SOMMER, *supra* note 52, ¶ 1122.06; Scott F. Norberg, *The National Bankruptcy Review Commission's Recommendation on Classification of Claims in Chapter 11*, 18 MISS. COLL. L. REV. 411 (1998).

167. 11 U.S.C. § 506(a)(1); FED. R. BANKR. P. 3017. For Chapter 11 rules on the valuation of collateral and determining the value of the secured claims, see, for example, ADLER, BAIRD & JACKSON, *supra* note 35, at 177–89; 4 LEVIN & SOMMER, *supra* note 52, ¶ 506. Bebchuk and Fried suggested a market-based mechanism to valuing collateral by selling a nonrecourse loan backed by the same asset. *See* Lucian A. Bebchuk & Jesse M. Fried, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 HARV. L. REV. 2386 (2001).

168. *See supra* note 54 and accompanying text.

costs described by the literature as leading to the failure to achieve the legislative objectives, as described above: the continuing decline in the firm's value and deviation from the APP.[169] In cases of institutional investors' powers, even if there is no deviation from the APP, the decline in value may be more severe.[170]

Notably, the factors identified in the literature that may give equity holders the power to extract value from debtholders under Chapter 11 are valid in all stages of negotiation and hearings for the assessment of the original rights and the distribution of the firm's value.[171] In cases of institutional investors' powers leading to ("fire") sales, findings show that debtors who sell have substantially lower recovery ratios than debtors who reorganize.[172] This can be explained as the creditors' surrender to the same powers now shifted to the management and institutional investors.

Moreover, litigation that oversees the allocation process and the firm's valuation occurs in reorganization until a plan is approved. In the case of a sale, both components may involve litigation until the sale. After the sale, litigation that oversees the original rights' assessment and the distribution of value continues.

The literature on litigation and settlement shows factors that may cause litigants to accept a settlement before or during trial for less than their legal rights,[173] and they join the factors that have been described above as infringing the unsecured creditors' rights. First, Bebchuk showed that, where a party to litigation is facing higher litigation costs during the continuation of trial, the other party can create a credible threat to continue the trial, entailing more litigation costs for

169. *See* discussion *supra* Section I.C.1.

170. *See* discussion *supra* Section I.C.2.

171. These factors include fear of liquidation, continued destruction of the firm's value, the equity holders' option to a value from a future success, the managers' exclusivity period, the managers' power to initiate bankruptcy proceedings, and fear of cramdown and sales. *See supra* Section I.C.1(b)(2).

172. *See supra* text accompanying notes 106–16.

173. For a broad review of the literature and theory of litigation and settlement, see Bruce L. Hay & Kathryn E. Spier, *Settlement of Litigation*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 442 (Peter Newman ed., 1998); Kathryn E. Spier, *Litigation*, *in* 1 THE HANDBOOK OF LAW AND ECONOMICS, *supra* note 71, at 259; J.J. Prescott & Kathryn E. Spier, *A Comprehensive Theory of Civil Settlement*, 91 N.Y.U. L. REV. 59 (2016).

the other party.[174] Therefore, the threatened party agrees to settle for less than his full legal right.[175] Hence, in the case of reorganization proceedings, the unsecured creditors are facing high costs of litigation during the continuation of hearings over their objections to managers' misuse of their power to estimate their claim, while the management that represents the interests of equity holders, itself, or the secured creditors bears no costs. Second, information asymmetry between parties might lead to the same outcome, where the less informed party agrees to a settlement with deviation from his legal right.[176] Again, unsecured creditors are the inferior side. Third, the same outcome occurs where uncertainty as to the ruling leads a risk-averse party to compromise with a less risk-averse party,[177] and fourth, where a party more sensitive to delays (has higher subjective discount rates) settles with a less sensitive party.[178] The third and fourth reasons may cause regular non-financial creditors, including workers, customers, and small business suppliers, to settle for less than their legal rights.

B. *The Gordian Knot Theory in Chapter 11 Proceedings*

1. *The Gordian Knot in Chapter 11's Allocation and Reallocation Stages*

There is a material connection between the AS and the RS—a Gordian knot—as they are essential stages of the negotiation between the same participants on the division of the same pie. The value of the claimants' new rights in the rehabilitated firm is determined by the value and the priority of their

174. *See* Lucian A. Bebchuk, *A New Theory Concerning the Credibility and Success of Threats to Sue*, 25 J. LEGAL STUD. 1, 3 (1996).

175. *See id.* at 23–24.

176. *See, e.g.*, Lucian A. Bebchuk, *Suing Solely To Extract a Settlement Offer*, 17 J. LEGAL STUD.437, 440 (1988); Avery W. Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 4 (1990); Alon Klement, *Threats to Sue and Cost Divisibility Under Asymmetric Information*, 23 INT'L REV. L. & ECON. 261, 261 (2003); Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267, 1270 (2006).

177. *See, e.g.*, Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279, 300 (1986).

178. *See* Osnat Jacobi & Avi Weiss, *The Effect of Time on Default Remedies for Breach of Contract*, 35 INT'L REV. L. & ECON. 13, 23 (2013).

original rights and by the firm's value. It is clear, for example, that if a creditor's original right is recognized to be worth half of its true value, and the firm's value is determined by a mechanism that will accurately price it, the creditor will receive only half of his right. Therefore, from the point of view of all negotiation participants, the determination of the original rights and that of the firm's value are essentially inseparable.

Furthermore, Chapter 11 reorganization proceedings are designed in a way that chronologically assigns the AS and the RS as parallel processes.[179] Specifically, the material information about the participants' rights arising from the AS and the formula for the distribution of rights that reveals the firm's value as arising from the RS must be included, towards the end of these stages, in the disclosure statement and be approved by the court after hearings. Later, after the claimants' meetings, they may become cause for objections in the plan approval hearings. Therefore, under Chapter 11 reorganization proceedings, determination of the original rights and determination of the firm's value are also structurally inseparable.

In the case of a sale, negotiation and litigation exist for both components until the sale, which may occur relatively early. Thereafter, litigation for determination of the original rights and their distribution continues once the firm's value has already been determined, according to the empirical findings, for a longer period.[180] As shown next, the same factors that enable extraction from unsecured creditors are still influential, leading to infringement of their rights.

2. *The Gordian Knot's Effects in the Case of Equity Holders' Powers*

Bebchuk and Chang developed a sequential bargaining model of the negotiations in Chapter 11 reorganization. In their model, from the commencement of a case, in each round of bargaining the firm's value decreases due to financial distress costs until the court converts the proceedings to Chapter 7 liquidation. They assumed that managers submit offers on behalf of equity holders. The managers submit all the offers in the exclusivity period. In the remaining time, the offers

179. For AS and RS proceedings, see *supra* Sections II.A.1 and I.C.1(a), respectively.

180. *See supra* text accompanying notes 106–11.

alternate. Each round, the party that submits an offer holds the other party to his expected payoffs in the next round (the value that the other party expects to receive in the next round of bargaining) and transfers to himself the "efficiency gains" that will be saved in this round of bargaining (the decrease in the firm's value during this same round).[181]

In equilibrium, the managers offer in the first round a plan that grants each party the value he will receive in liquidation and the value he will receive in each round where he is expected to offer a plan, and everyone agrees. This divides the reorganization pie in a way that gives the equity holders the savings from the unsecured creditors' expected losses from all rounds of bargaining in which the managers are expected to submit an offer. Therefore, even in cases where equity holders are not entitled by the APP to receive value, the outcome of the bargaining is that they gain part of the reorganization pie.[182]

In principle, under Chapter 11's structured bargaining, adding bargaining even to the value of the secured creditors' original rights will not change the basic outcome of the negotiation. In each round of bargaining, the unsecured creditors bear additional litigation costs to prove their rights (as an example of a cause for biases in the outcome of trial negotiations and settlements). This gives more extraction power to managers vis-à-vis unsecured creditors, and in turn decreases their share.

3. *The Gordian Knot's Effects in the Case of Institutional Investors' Powers*

Bebchuk and Chang explained that their model could be adjusted to suit alternative assumptions, for example, in a case where the managers may serve the interests of the debtholders.[183] As a result, the debtholders would capture all surplus from saving the financial distress costs of the exclusivity period.[184]

To demonstrate a more dire case, assume that secured creditors control an insolvent firm, and there is no value to the

181. *See* Bebchuk & Chang, *supra* note 90, at 256–61.
182. *Id.* at 261–64.
183. *Id.* at 267.
184. *Id.*

equity holders' option to gain from the firm's future success.[185] Also assume that the managers know that the firm's value is V=150, its liquidation value is L=120, and the secured and unsecured debt is each $D_S=D_{US}=100$.[186] The exclusivity period lasts up to half the time for liquidation. In this case, the parties know that the unsecured creditors are entitled to a value of 50 ($V–D_S=150–100$), which gives them one-third of the rehabilitated firm's shares. Under the proposed plan, the managers do not assign any value to equity holders, which is consistent with the APP. The managers offer unsecured creditors, however, a value of only 27.5 ($L_{US}+0.25(V–L)= 20+0.25(150–120)=20+7.5$) by offering them 18.3% of the rehabilitated firm's shares, which they accept.

Next, I examine, in light of the proposed theory, whether the alternative mechanisms suggested by the literature that focused on the firm's valuation problem and its solution by market mechanisms—including by firms' sale under Chapter 11—may achieve the legislative objectives.

C. *Applying the Gordian Knot Theory to Alternative Mechanisms*

1. *Bebchuk's Options Model and Adler and Ayres' Model*

Bebchuk's options model is a market mechanism suggested as an alternative to the current Chapter 11 RS. Bebchuk showed that the mechanism prevents deviations from the APP and from claimants' rights, regardless of the materialization of the firm's value.[187] As Bebchuk explained, its operation starts after the AS:

> The proposed reorganization regime will include, as any reorganization regime must, a preliminary process of determining the size and ranking of participants' claims; this process may be straightforward at times, but it also may be complex and time-consuming at other times. Once the participants' claims are

185. The same outcome is expected even in a case where the value of the equity holders' option to gain from the firm's future success is positive but lower than their litigation costs.

186. In a case where the unsecured creditors bear legal costs to prove their original rights and the secured creditors do not bear such costs, the managers will have additional extraction power, which leads to an equilibrium with less value to the unsecured creditors.

187. *See supra* Section I.D.2.

identified, however, the process of division will proceed smoothly and quickly.[188]

As demonstrated in the article, under the current Chapter 11, the AS is performed by bargaining and litigation, leading to deviations from legislative objectives. Therefore, as the Gordian knot theory suggests, even with an efficient RS that follows Bebchuk's options model, the outcome of the two successive stages will not achieve the legislative objectives.

Adler and Ayres' dilution mechanism grants senior creditors all of the shares and allows junior classes to buy new shares until there is no excess demand for the stocks at a price that would implement the APP.[189] As in Bebchuk's options model, which forms the foundation for their mechanism, its operation depends on the conclusion of a preliminary process of determining the size and ranking of participants' claims and therefore is unable to attain the legislative objectives without a mechanism that perfectly solves allocation problems.

2. *Baird's Auction Method, the Current Chapter 11's Sales, and Roe's Partial Sale*

Baird suggested that an auction of the firm would take place shortly after a public company files for bankruptcy.[190] As mentioned above, he argued that this mechanism separates between two main bankruptcy processes: the determination of how the firm's assets are used and the determination of the claimants' rights to assets.[191] An auction stops the ongoing destruction of the firm's value by deciding the issue of ownership and allowing the management to optimally implement business plans. An auction determines the firm's value, which creates certainty and in turn eases the task of determining the claimants' rights.[192]

The Gordian knot theory suggests, however, that minimizing valuation uncertainty by the firm's auction or sale cannot eliminate the firm's value destruction nor deviations from the APP. Determining the size and priority of the claimants' rights is necessary for an insolvent firm's auction or sale, as it is nec-

188. Bebchuk I, *supra* note 1, at 798.
189. *See supra* Section I.D.5; *see also infra* Section II.C.2.
190. *See supra* Section I.D.3.
191. *See supra* Section I.D.3.
192. *See* Baird II, *supra* note 1, at 638–39

essary for its reorganization. Under Chapter 11 sales, part of the AS is done before the sale and it continues afterwards. In the absence of other AS mechanisms, auctions and sales can cause irreparable harm to claimants whose right had been initially determined as unsecured, but after hearings was recognized as secured, as the sale's proceeds are insufficient to compensate those property right owners. If, after the sale of the ownership in the firm, corrections are made in retrospect through the granting of rights in the firm (by issuing the firm's securities or granting rights to its assets), the buyer will ex-ante offer lower value for the firm. The risk of not getting the value of their rights might push claimants to immediately settle for less.

As Baird noted, disputes over claimant rights, including collateral valuations, claims' classification and priority, tax disputes with the authorities, and executing of guarantees for loans between the public company's subsidiaries require costly litigation.[193] Most importantly, the length of the current proceedings occurring after a sale[194] indicates that their costs are high, with problems of asymmetric information and uncertainty as to the ruling. These costs can cause the unsecured creditors to agree to a value lower than their legal rights, which may also have negative *ex ante* effects. Furthermore, complex disputes might mitigate the company's ability to rehabilitate, even with new owners. Continuous disputes with customers, suppliers, or workers, for example, might negatively affect the company's outcomes and cause potential buyers to lower the purchase price.

Roe's partial sale, which is aimed to reveal the firm's value by selling a fraction of the reorganized company's shares, requires solutions to the allocation questions.[195] If it does so by bargaining and litigation before and after the sale, the results, in terms of destruction of the firm's value and deviation from the APP will be the same as under Baird's auction method and Chapter 11 sales.

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193. *Id.* at 638.
194. *See supra* notes 106–16 and accompanying text.
195. *See supra* Section I.D.1.

3. *Aghion, Hart, and Moore's Model*

Aghion, Hart, and Moore followed Bebchuk's options model in their model's first stage and added another stage of voting.[196] Hence, as discussed above, the conclusion of the AS is crucial for its operation, and without a mechanism to achieve it the legislative objectives cannot be attained.

Aghion, Hart, and Moore claimed that even though the three months they determined for establishing the original rights and priorities and for operating the mechanism may not be enough for complex litigation, settling a reasonable proportion of the claims is sufficient, and the remainder could be settled after voting.[197] They claimed that as in liquidation proceedings, some proceeds would be held in an interest-bearing escrow account and disbursed when the claims are resolved.[198]

The Gordian knot theory focuses on the resilience and strength of the connection between the bankruptcy processes. First, in an insolvent firm with complex disputes, adopting rules that determine the temporary value and priority of claimants' rights seems very challenging. In particular, there are disputes in various fields, such as labor, customer, supplier, and lender disputes. There are also special provisions in contracts for insolvency situations, such as penalty interest, and links between contracts, such as claims acceleration clauses and guarantees. Secured creditors are entitled to demand adequate protection for the collaterals or their execution. In this situation, it is required to establish criteria for the temporary determination of the disputed value and priority of the rights between the claimants' statement and the company and other claimants' versions. Such criteria are assumed to be arbitrary and may result in infringement of creditors' rights, who would consequently agree to a settlement at a low value. Second, bargaining and litigation will take place in the three months preceding the implementation of the reorganization plan and will continue for a long time after. As in the case of auctions or sales,[199] it is expected that a potential buyer would lower the

196. *See supra* Section I.D.4.
197. Aghion, Hart & Moore I, *supra* note 20, at 541; Aghion, Hart & Moore II, *supra* note 20, at 867–68.
198. Aghion, Hart & Moore I, *supra* note 20, at 541.
199. *See supra* Section II.C.2.

purchase price and that claimants would agree to a lower settlement than they are legally entitled to.

D. *Gordian Knot Theory as a General Theory of Bankruptcy Proceedings*

The discussion about the connection between the AS and the RS shows that whenever bargaining and litigation occur before the new ownership is determined, as in Chapter 11 reorganization or in most mechanisms that aim to construct a hypothetical sale, a lengthy trial to determine the participants rights may decrease the reorganization's value and create litigation costs. The participants can avoid this outcome by deciding to settle. Nevertheless, this decision might induce infringements of inferior classes' rights. Even with an efficient mechanism for determining the firm's value by sale that leaves most bargaining and litigation to occur after a sale, inferior classes' rights will be infringed on.

This reasoning is valid for all stages or processes of reorganization proceedings connected structurally and materially, i.e., where bargaining or hearings take place on the distribution of the same reorganization pie. Even if legislation adopts a mechanism for performing one stage efficiently, ongoing destruction of the reorganized firm's value and deviation from the claimants' rights still occur. This happens under two conditions: (1) there is a structural connection between several stages or processes of the bankruptcy proceeding that aim to distribute the same firm's value between the claimants ("Gordian knot"); and (2) at one or several stages of the proceedings, bargaining or litigation between the claimants over the distribution of the firm's value leads to ongoing destruction of firm's value or infringement of their legal rights.

The Chapter 11 commencement stage serves as an example. Chapter 11 allows managers to file for reorganization and commence the voluntary case without proving insolvency.[200] This enables managers to bring the case to court at a time when rehabilitation is still possible. Managers might exploit the ease of opening a proceeding and file to avoid payments to creditors or to renegotiate contracts without valid reorganizational necessity. To check the balance between these advantages and disadvantages, the court has the power to dismiss the

200. *See supra* note 52 and accompanying text.

case for cause, including for lack of good faith.[201] This judicial discretion can give rise to litigation with vague standards. Commencement of an involuntary case, which is much less common than a voluntary case, requires the petitioner creditor to meet more stringent conditions, including the firm's insolvency, and involves careful scrutiny of the filing.[202] These terms may cause litigation over the commencement criteria. Notably, the court has the discretion to dismiss an involuntary case for bad faith—for example, in a case where a creditor files to injure a competitor.[203] Applying the Gordian knot theory to problems at the commencement stage of a bankruptcy proceeding indicates that litigation at this stage might destroy the firm's value and enable the parties who bargain over the bankruptcy pie to extract value similarly to how they would in the AS.

Notably, adding a new stage of bargaining and litigation might increase the infringement of inferior classes' rights. To mitigate this infringement, the ABI Reform suggested a redemption option value to junior classes to be exercised three years from the bankruptcy petition.[204] Adding this stage, however, might cause the reverse effect of more bargaining and

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201. *See, e.g.*, 9B AM. JUR. 2d *Bankruptcy* § 1873 (2021).

202. *See* ADLER, BAIRD & JACKSON, *supra* note 35, at 66–79 (explaining that an involuntary application requires careful examination); Nathan L. Rudy, *Robbing Your Rival's Piggybank: The Third Circuit Affirms Bad Faith Dismissals in Involuntary Bankruptcies After In re Forever Green Athletic Fields, Inc.*, 61 VILL. L. REV. 705, 705 (2016); *see also supra* note 52 and accompanying text. Chapter 11 allows involuntary case filing against a debtor by three or more claimants, each of whom holding a claim that "is not contingent as to liability or the subject of a bona fide dispute as to liability or amount . . . if such noncontingent, undisputed claims aggregate at least $10,000 more than the value of any lien on property of the debtor." 11 U.S.C. § 303(b). If the petition is controverted, the creditors must prove at trial that "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute as to liability or amount." 11 U.S.C. § 303(h).

203. *See* 9B AM. JUR. 2d *Bankruptcy* § 1021 (2021); Rudy, *supra* note 202, at 723. For a call to explicitly enshrine in law the power of the court to dismiss an involuntary proceeding due to the lack of good faith of the creditor, see Amir Shachmurove, *The Consequences of a Relic's Codification: The Dubious Case for Bad Faith Dismissals of Involuntary Bankruptcy Petitions*, 26 AM. BANKR. INST. L. REV. 115 (2018).

204. *See supra* Section I.E.1.

litigation, leading to a further decrease in the firm's value and further infringement of junior classes' rights.[205]

The literature views the pre-bankruptcy negotiation on workouts as another stage of reorganization bargaining.[206] The parties can save the financial distress costs that occur at that pre-bankruptcy stage and settle. The expected settlement in bankruptcy is a threat point to the negotiators, and in workouts (if holdup and asymmetric information problems do not prevent a settlement at this stage), the junior classes are expected to agree to an infringement of their legal rights, knowing their expected value in bankruptcy.

Next, I propose the reorganization without bankruptcy mechanism, which has the advantage of operating at a stage when the firm has not yet breached its contracts or begun bargaining or litigation of the bankruptcy AS. I argue that this mechanism may achieve the legislative objectives of maximizing the firm's value and dividing it according to the APP.

III. REORGANIZATION WITHOUT BANKRUPTCY: THE MECHANISM AND ITS ADVANTAGES

A. *The Proposed Mechanism*

1. *Definitions*

In this section, the following definitions apply:

(a) Company – An issuer whose stocks are traded on at least one stock exchange.[207]

(b) Creditor – An entity that has a claim against a company arising from the company's financial liabilities.

(c) Claim – "[R]ight to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."[208]

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205. *See* Adler & Triantis, *supra* note 145, at 590–92.

206. *See, e.g.*, Bebchuk & Chang, *supra* note 90, at 269–70. For discussion on workouts and possible reasons for their failure, see *supra* Section I.E.2.

207. In this section title, the following definitions apply: *exchange* – as defined in section 78c(a)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c; *issuer* – as defined in section 78c(a)(8) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c; *stock* – an equity security as defined in section 78c(a)(11) of the Securities Exchange Act of 1934, 15 U.S. C. § 78c.

208. 11 U.S.C. § 101(5)(A) (West 2020).

(d) The company's financial liabilities – The legal obligation to repay to the entities that have funded the company.

(e) Secured creditor – A creditor whose claim is secured by a lien on any of the company's properties.

(f) Unsecured Creditor – A creditor whose claim is not secured by a lien on any of the company's properties.

(g) Claimants – The secured and unsecured creditors and shareholders.[209]

(h) The effective day – The last day of the twelve-month period starting after the registration of a going-concern warning in the company's financial statements that has not been removed, and, if an exercise notice of a class is given, the last day of the thirty-day period starting after such notice becomes effective.

(i) Exercise notice of a class – Exercise notices submitted by claimants are considered an exercise notice of a class of shareholders, unsecured or secured creditors, if given by claimants of such class who do not hold claims in a preferred class (hereinafter uninterested claimants) and hold at least one-half in amount of claims by the uninterested claimants of the class.

(j) Deposit of the exercise price by a class –

> (1) Deposit of the exercise price by shareholders or unsecured creditors if given by uninterested claimants of such a class who hold at least one-half in amount of claims by the uninterested claimants of such a class; *or*
>
> (2) The submission of notices by secured creditors who hold at least one-half in amount of claims of such a class declaring their consent to convert their claims, including secured bonds, to new shares.

2. *A Mechanism for Reorganization Without Bankruptcy*

(a) If until thirty days prior to the effective day an exercise notice of a class has been accepted and by the end of the effective day deposits of the exercise price by a class have been guaranteed (hereinafter acceptance of a reorganization plan), the claimants' current claims against the company are re-

209. In this section title, a *shareholder* is an entity that holds stocks of the company.

voked, and the company issues new shares to its claimants, then:

> (1) In case of deposit of the exercise price by shareholders, they will become the owners of the new shares at a price equal to the amount of the company's financial liabilities, and in such a case, the creditors' right to owning the new shares stated in subsections (2) and (3) below will be redeemed;
> (2) In case of deposit of the exercise price by unsecured creditors, they will become the owners of the new shares at a price equal to the amount of the company's secured financial liabilities, and in such a case, the secured creditors' right to owning the new shares stated in subsection (3) below shall be redeemed;
> (3) The secured creditors will become owners of the new shares without payment.

(b) After the registration of a going-concern warning in the company's financial statements and until the effective day, each claimant will be entitled to submit an exercise notice, and after the submission of an exercise notice of a class, to deposit the exercise price.

(c) If by the end of the effective day, a reorganization plan under section (a) of this chapter has not been accepted, it will be deemed cause for the commencement of a case under Chapter 7 of this title.

(d) If a petition for a commencement of a case under Chapter 7 of this title has been filed, it will be deemed registration of a going-concern warning in the company's financial statements, and in such a case, if until by the end of the effective day a reorganization plan under section (a) of this chapter has not been accepted, such a petition will be considered to have been resubmitted.

B. *The Mechanism's Applicability and Objectives*

1. *Applicability of the Law and Case Commencement*

The law applies to any public companies with a GCW included in its financial statement. Generally, as stated above, where there is substantial doubt as to whether the firm could remain solvent over twelve months, its external auditors have to issue an opinion to that effect. To enable the GCW to be a specific and efficient criterion for the mechanism's commencement, it is suggested that the self-regulators or the law define the type of the GCW suitable for this matter, the process to create it and its content.[210] If due to the management's efforts or other reasons there is no longer cause for including the note in the financial statements and it is erased, the proposed law will no longer apply to this company.

2. *The Players in the Proposed Law and Attaining the Legislative Objectives*

In accordance with the proposed law, an option to purchase the company is offered to the equity holders and to the company's credit suppliers only. If the claimants (or part thereof) decide to exercise the options, there will be at most three classes of players in the game: secured and unsecured credit providers and residual claimants. The price the claimants will need to pay to purchase the company equals the amount required to repay all the company's credit obligations toward higher classes of creditors. The idea underlying this proposal is based on the understanding that a company that is a candidate for reorganization should be able to meet its current obligations if its outstanding liabilities are erased. At this stage, operation contracts have not been breached, and obligations under these contracts should be paid from income and new debt as expected of such companies.

The mechanism follows Bebchuk's options model and preserves its advantages: maximizing the company's value by a market mechanism without deviation from the APP.[211] Sections 2(a)(1)–(3) of the proposed law determine the options' order of exercise on the closing day. Priority in exercising the options is given first to the equity holders, then to the junior creditors, and finally to the senior creditors. To demonstrate, suppose that all rights holders exercise their options. In such a case, the shareholders will receive all the shares in the rehabilitated company. The price paid by them will be used for prorata redemption of junior and senior creditors. Now suppose that only the creditors (both junior and senior) and no share-

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210. For a definition of GCW under the proposed reorganization without bankruptcy mechanism and a discussion of the conditions for its issuance, see *infra* Section III.D.3.

211. For a presentation of Bebchuk's Options Model, see *supra* Section I.D.2.

holders exercise their options. In this case, the junior creditors will receive all the company's new shares while the proceeds received will be used to repay the senior creditors. Finally, if only the senior creditors but no other classes of claimants exercise the options, the senior creditors will end up with all the shares in the reorganized firm. As Bebchuk proved, this method prevents deviations from the APP and the claimants' rights, regardless of the materialization of the company's value.[212] Furthermore, market evaluation guarantees a perfect assessment of the company's value, especially where the options are traded, which may also provide liquidation. Since the parties' outcomes do not depend on their declared estimations of the company's value, there is no incentive for strategic manipulation by the parties to promote the value so as to maximize their shares.[213]

As explained above, the Gordian knot theory's lesson is that to attain the legislative objectives, the allocation of rights could not be performed by bargaining and litigation. In order for the mechanism to operate, it is suggested that this task be based on the securities trading system, the company's financial statements, and its accounting system. This includes the determination of the amount of the company's unsecured and secured financial liabilities. To complete this task efficiently, financial statements should contain assessments of the collaterals' value.[214]

Attaining the legislative goals is easier under the proposed mechanism because it is limited to equity holders and credit suppliers and because there are no complicated allocation problems. For example, without complex securitization tasks of creating and listing nonfinancial obligations, listing a new debt for trading before the effective day seems a relatively simple task. In turn, this will make the determination of the company's value more accurate and facilitate the financing of the purchase of the rehabilitated company's shares.

212. *See* Bebchuk I, *supra* note 1, at 786–92; Bebchuk II, *supra* note 1, at 838–39. *See also supra* notes 131–33 and accompanying text.

213. *See* Bebchuk I, *supra* note 1, at 793–98; Bebchuk II, *supra* note 1, at 838–42.

214. A complementary rule may be considered whereby, if necessary, the valuation of collaterals could be performed by Bebchuk and Fried's market-based mechanism to valuing collateral by selling a nonrecourse loan backed by the same asset. *See* Bebchuk & Fried, *supra* note 167, at 2409–10.

Notably, as the literature explains, maximizing the company's value and preserving the APP also have the ex-ante effect of preventing inefficiencies in the pre-reorganization period, where deviation from the APP might cause suppliers of goods and services, including loans and other financial services, to request higher prices.[215] These deviations exacerbate the moral hazard problem that causes managers to favor risky projects over safe ones.[216] Avoidance of these effects increases the likelihood of the company's survival.

3. *Solving Allocation Problems Under the Proposed and Alternative Mechanisms*

One of the main advantages of the proposed law is its ability to untie the Gordian knot of the bankruptcy process that binds together the allocation and reallocation processes. By operating in the pre-bankruptcy period, when the firm is solvent and has not breached its contracts, this mechanism eliminates the complex allocation disputes that lead to the destruction of the firm's value and to deviations from claimants' legal rights. By operating before the company's bankruptcy, this mechanism saves the high costs involved in implementing some of the bankruptcy laws. At this stage, there is no need for litigation over allocation disputes, including verifying claims and rankings, releasing collateral that is not adequately protected, or rejecting or reinstating executory contracts.[217]

The reorganization without bankruptcy mechanism could be adjusted to be based on alternative efficient valuation and reallocation mechanisms, including auctions. Transferring an alternative mechanism to the pre-bankruptcy environment will avoid bargaining and litigation costs for solving allocation problems, loss of company value, and deviation from the APP. If the reorganization law is based on Adler and Ayres' model, reorganization can start immediately without any allocation costs.[218] And if it is based on Baird's auction method or on Aghion, Hart, and Moore's model, litigation and bargaining

215. *See supra* Sections I.A., I.C.1(b).

216. *See, e.g.*, Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, *supra* note 33, at 447; Adler, *supra* note 47, at 463, 486.

217. For the allocation problems of bankruptcy law, see *supra* Section II.A.1.

218. *See supra* Section II.C.1.

costs before and after the operation of the mechanism will be saved.[219] As argued above, destruction of the company's value occurs before the sale, and even with a sale that transfers the company to new owners, the latter expect to pay less for a company with unresolved complex disputes that might mitigate the company's ability to rehabilitate.[220] With a decreased company value and continuous bargaining and litigation, claimants are expected to settle for less than the true value of their right.

Under Section 2(c) of the proposed law, a reorganization plan's failure is considered a cause for the commencement of liquidation proceedings. If these proceedings are based, for example, on Baird's auction model, their immediate operation while the firm is solvent or even on the verge of insolvency is free of complex allocation disputes and may yield efficient outcomes.

The law should prohibit attempts to create an artificial allocation problem. Accordingly, registration of a GCO in the company's financial statements will not be considered a breach of contract. Furthermore, the opinion will not be cause for applying a penalty clause, or for exercising collateral.

4. *Optimal Rehabilitation Process and Capital Structure*

The proposed law does not interfere with the solvent company's decision-making process and enables managers to do their best to achieve optimal rehabilitation, including an optimal capital structure, in a way that will maximize the company's value and attract investors. This is different from current law, where, as the literature argues, the parties' strategic behavior during Chapter 11 bargaining and litigation not only compromises the company's value and the claimants' rights but leads to an inefficient capital structure for the reorganized firm.[221]

Generally, managers have incentives to choose optimal business plans and capital structures to avoid bankruptcy, and inter alia, to protect their reputation. It is questionable, however, how firm those incentives are, and whether their aggre-

219. *See supra* Sections II.C.2. and II.C.3., respectively.
220. *Id.*
221. *See, e.g.*, Roe, *supra* note 10, at 536–46; Bebchuk I, *supra* note 1, at 780.

gate incentives can be predicted, taking into account counter-incentives, such as gaining from deviations from the APP and from risky projects.[222] By preventing profits from deviating from the APP, the proposed mechanism strengthens the incentives for managers to work for the company's rehabilitation, including making optimal decisions about the company's capital structure. As Bebchuk noted, after purchase by a reorganization plan, the managers will take all steps to promote efficient operation.[223] This argument applies to decisions changing the company's capital structure.[224]

Furthermore, under the proposed law, the entire rehabilitation process is carried out while the company is still solvent and can meet its obligations. Therefore, it has no debts nor debtholders to file for court protection that restricts the management's ability to act. Moreover, it is easier to borrow money for operation than to repay debts for breached contracts, as is often the case in a Chapter 11 reorganization. Since the company is still solvent, potential lenders may finance it more easily and under better conditions.

5. *Converting into Chapter 7 Liquidation*

Until the end of the effective day, if no claimant class has exercised its options, the reorganization process fails. As long as the company is solvent, one of the claimant classes will profit from exercising its options. Hence, avoiding execution by any of the claimant classes indicates that the company is worth less than the value of its assets and is insolvent. Therefore, Section 2(c) of the proposed law states that failure of the reorganization process is a ground for commencing liquidation proceedings under Chapter 7 of the Bankruptcy Code.[225]

According to the proposed law, the rehabilitation process ends when the company becomes insolvent and the recovery process may not be repeated after insolvency. This restriction is placed on the process to prevent deviation from the legislative objectives. Otherwise, leaving the company in reorganization proceedings after insolvency requires court proceedings to determine the amount of debt owed to the various creditors

222. *See, e.g.*, Cabrillo & Depoorter, *supra* note 34.
223. *See* Bebchuk II, *supra* note 1, at 837–38.
224. *See id.* at 834.
225. *See supra* Section III.A.2.

and their priorities, which causes the reorganization value to shrink and might result in deviation from the APP.

As stated in Section 2(d), reorganization is the default mechanism, and if a petition for commencement of a case under Chapter 7 has been filed, it activates the reorganization mechanism, which will lead to liquidation only if it fails.[226] Next, I present the proposed mechanism timeline and operation, including of the exercise notice tool (included in Sections 2(a)–(b) of the proposed law) that enable the classes to purchase the reorganized company.

C. *The Proposed Mechanism's Timeline and Operation*

1. *Timeline*

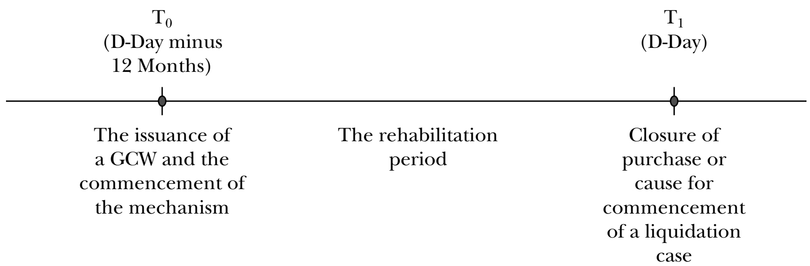

FIGURE 1: THE REORGANIZATION WITHOUT BANKRUPTCY MECHANISM'S TIMELINE

The company's reorganization without bankruptcy proceedings commence automatically on the day of issuance of a GCW (T_0) and apply for a period of twelve months (until T_1), which is the period wherein the company is expected to continue as a going-concern. This period will be shortened if one of the claimant classes executes the options before T_1.

During the rehabilitation period (T_0–T_1), the company is solvent, meets all its current liabilities, and its stocks and bonds are traded in the market. By T_1, the applicability of the law ends, with one of two possible outcomes. One possibility is that one of the claimant classes has exercised its right to acquire the company's shares. In this situation, the company's credit liabilities are canceled and the company issues new shares instead in accordance with the exercise of the options

226. *See supra* Section III.A.2.

(as stated in Section 2(a) of the proposed law), i.e., a reorganization plan has been accepted. Another possibility is that none of the groups exercised their right under the law, which as explained above is an indication that the company is worth less than the value of its assets and is insolvent, and therefore, this is considered a cause for liquidation proceedings (as stated in Section 2(c) of the proposed law).[227]

2. *Operation*

a. Plan Acceptance

Under the proposed law, after the commencement of a case by GCW registration and during the twelve months, the classes of equity holders and secured or unsecured creditors may accept a reorganization plan if two cumulative conditions are met (Sections 2(a)–(b) of the proposed law). The first is that until thirty days prior to the deadline, an exercise notice of a class has been submitted. The proposed law enables each claimant to submit a personal exercise notice for his right and the class's decision to exercise the options is made by majority vote. The voting rule determines that if uninterested claimants (who do not hold claims in a preferred class) who hold at least one-half in amount of claims by the uninterested claimants in their class submit personal exercise notices, then these personal notices constitute an exercise notice of the class. Another condition is that by thirty days after an exercise notice of a class has been accepted (and no more than twelve months after the GCW registration), the exercising class deposits the amount that constitutes the exercise price of the necessary majority of uninterested claimants in such a class.

According to the proposed law, the classes may allow the management to implement the rehabilitation plan in full, and if the warning is not revoked, to submit the exercise notices toward the deadline (until thirty days before twelve months have passed). To avoid manipulations and to deal with malfunctioning management, each of the three classes has the power to advance the acceptance of a reorganization plan by submitting early exercise notes.

To avoid holdups and coercion problems in the classes' decision-making on the acceptance of a plan, including early

227. *See supra* Section III.A.2.

acceptance, the mechanism separates the classes' voting by submitting the exercise notes and the personal purchase decision by depositing the exercise price. If 50% of the claimants of a class who do not have holdings in a superior group have submitted a personal exercise notice, the reorganization manager will give notice to all the claimants stating that an exercise notice of a class has been issued. This announcement begins a thirty-day period, in which all participants can choose whether to personally execute their options by depositing their purchase price (as specified in Section 1(i)–(j) of the proposed law). The diagram below summarizes the process of exercising the options:

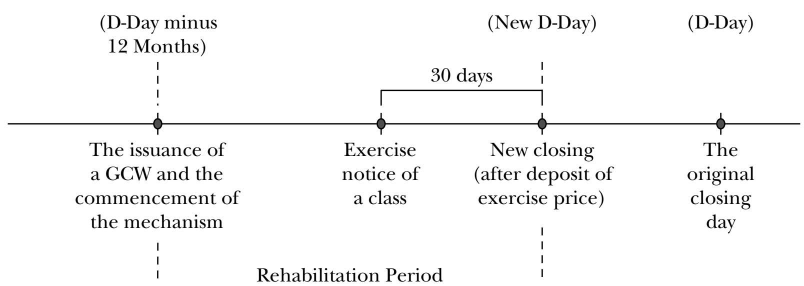

FIGURE 2: THE REORGANIZATION WITHOUT BANKRUPTCY MECHANISM'S TIMELINE—AN EXERCISE NOTICE OF A CLASS AND THE EARLY CLOSING OF THE REORGANIZATION PLAN

b. Distributing the New Shares

After the submission of an exercise notice of a class, claimants of this class may deposit the exercise price, and if 50% of the uninterested claimants of such a class deposit their purchase price, the reorganization plan is considered accepted. Notably, in the thirty days beginning after the submission of an exercise notice of a class, other claimants from all classes are entitled to submit exercise notices and deposit the exercise price.

A further rule is suggested, whereby when a class accepts a plan, whether all or part of its exercise price is deposited, claimants of its inferior class who have deposited the exercise price shall receive new shares according to their share of the exercise price of such inferior class. For example, if a plan has been accepted by unsecured creditors, the rule would allow individual shareholders who have deposited the exercise price to receive their relative share of the new equity. This rule may increase the amount to be used to repay financial obligations. It would also meet a possible claim of claimants of inferior classes that, despite the class's decision not to participate they believe that the company's value is higher than the class's assessment and that their participation will better preserve the value of their original right.[228]

Notably, if there are remaining shares after the exercise of the unsecured creditors, the remaining new shares will be distributed proportionally among the secured creditors for no consideration. With the implementation of a reorganization plan, the claimants' original claims against the company will be revoked.

D. *The Proposed Mechanism's Advantages*

1. *Maximizing the Firm's Value, Preserving Claimants' Rights, and an Optimal Managerial Decision-Making Process – Summary of Previous Conclusions*

Above, I discuss the proposed mechanism's advantages, including its ability to attain legislative objectives; ability to accurately determine the company's value based on market trading that prevents manipulation and provides liquidation; the management's decision-making efficiency, including the rehabilitation plan and capital structure; and the operational and financial advantages of rehabilitation at the pre-bankruptcy period.[229] I further discuss the complementary methods to avoid manipulations and to deal with malfunctioning management by early plan acceptance and majority voting rules. Furthermore, members of a class that does not accept the plan may deposit their execution price and protect their rights' subjective value.[230]

Next, I discuss further advantages. First, I argue that the mechanism may restore investors' trust in management's voluntary rehabilitation moves and their willingness to invest. Second, the mechanism's commencement costs are expected to be minimal. Furthermore, it may restore management's incen-

228. *See* Bebchuk I, *supra* note 1, at 794–95.
229. *See supra* Section III.B.
230. *See supra* Section III.C.2(b).

tives to truthfully disclose the company's conditions that give rise to discussion on GCO registration.

2. *Investor Trust*

Investors' reliance on funding plans' truthfulness is crucial. The experience with workouts shows that they tend to fail, a tendency explained by the literature, inter alia, as a problem of adverse selection—meaning that creditors cannot differentiate real financial difficulties from strategic difficulties and therefore do not trust firms' reorganization plans.[231] As argued above, the proposed mechanism may prevent the destruction of a firm's value and deviations from the APP, and reverse negative effects of inefficiencies in rehabilitation and funding plans. In turn, this may encourage investors to trust plans in the twelve-month voluntary rehabilitation period, despite the financial difficulties, which enables funding, decreases its costs, and increase the likelihood of rehabilitation. Notably, after a reorganization plan's acceptance, managerial decision-making is expected to be efficient.[232]

3. *Going-Concern Warning as a Criterion for Case Commencement and Managers' Incentives*

a. Case Commencement Costs Under Chapter 11 and the Proposed Mechanism

Another question related to bankruptcy proceedings' efficiency is whether they provide managers with efficient incentives to disclose information truthfully. Findings show that managers tend to withhold bad news and have incentives to delay reorganization's filing, inter alia, to protect their reputation and escape the creditors' growing powers in bankruptcy,[233] and that this behavior is exacerbated by manage-

231. *See supra* Section I.E.2.
232. *See supra* notes 223–24 and accompanying text.
233. *See, e.g.*, S. P. Kothari, Susan Shu & Peter D. Wysocki, *Do Managers Withhold Bad News?*, 47 J. ACCT. RSCH. 241 (2009); Barry E. Adler, Vedran Capkun & Lawrence A. Weiss, *Theory and Evidence on the Bankruptcy Initiation Problem* (America Law & Econs. Ass'n Ann. Meetings, Working Paper No. 53, 2006), https://law.bepress.com/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1655&context=alea; White, *supra* note 71, at 1032–34; *See, e.g.*, Zane Swanson & John Theis, *Study of Going-Concern Opinions*, 34 J. ACCT. AUDITING & FIN. 347 (2019) (showing that man-

ment heuristics and cognitive biases.[234] Where managers act strategically and file to escape the company's liabilities, they might conceal the company's true positive condition. If they are trying to escape the bankruptcy proceedings, they might have an incentive to conceal the company's true negative condition.

As described above, the Chapter 11 commencement stage comes with bargaining and litigation that might destroy the firm's value and enable the parties who bargain over the bankruptcy pie to extract value similarly to the way they extract value in the AS.[235] The proposed reorganization without bankruptcy mechanism, however, is triggered by the GCW that is based on objective procedures and data, as assessed by the management and auditor. The warning is not expected to give rise to litigation and bargaining. Therefore, a warning as a basis for the suggested mechanism saves Chapter 11 commencement costs and comes with minimal cost since it is based on ongoing auditing procedures and assessments. Especially, it triggers proceedings without infringing on the legislative objectives.

Furthermore, since the proposed mechanism does not allow deviation from the APP, it will decrease the pressure on the management from secured creditors or shareholders to act in their favor. As stated above, to avoid artificial allocation problems, the registration of a GCO in the company's financial statements will not be considered as a breach of contract or cause for applying a penalty clause, or for exercising collateral.[236] This may mitigate the managers' fear of the secured creditors' powers. Hence, the mechanism may restore the managers' incentives to adequately disclose the company's situation even if this would lead to a registration of a GCO that might in turn, lead to the registration of an explicit warning. Next, I review the criteria for issuing a GCW.

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agement tends to make sections of company reports more difficult to read when they convey bad news and when they include a GCO).

234. *See* Michelle M. Harner & Jamie M. Griffin, *Facilitating Successful Failures*, 66 FLA. L. REV. 205, 210 (2014).

235. *See supra* Section II.D.

236. *See supra* Section III.B.3.

b. Criteria for Case Commencement Under the Proposed Mechanism

The Financial Accounting Standards Board (FASB)—an organization that establishes financial accounting and reporting standards for public and private companies that follow the Generally Accepted Accounting Principles (GAAP) within the United States[237]—issued an amended accounting standard that covers going-concern issues effective for financial statements ending after December 15, 2016.[238] The standard requires the management and auditor to evaluate and disclose "substantial doubt" about the entity's ability to continue as a going concern in a note to the financial statements.[239] Under

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237. For this organization's structure and mission, see *About the FASB*, THE FINANCIAL ACCOUNTING STANDARDS BOARD (FASB), HTTPS://WWW.FASB.ORG/JSP/FASB/PAGE/SECTIONPAGE&CID=1176154526495.

238. FASB Accounting Standards Update (ASU) 2014-15, *Presentation of Financial Statements (Subtopic 205-40)—Going Concern: Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*, 2–4 [hereinafter FASB Accounting Standards Update]. Another source for the duty to issue the warning is the standards of the Public Company Accounting Oversight Board (PCAOB)—a nonprofit corporation established by the Sarbanes-Oxley Act of 2002 to oversee the audits of publicly traded companies to protect investors—directed to the auditors of those companies. For PCAOB structure and mission, see *About the PCAOB*, THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), https://pcaobus.org/About. International standards for auditing are also determined by the International Auditing and Assurance Standards Board (IAASB). IAASB is an independent standard-setting body, supported by the International Federation of Accountants (IFAC) that serves the public interest by setting high-quality international standards for auditing and by facilitating the convergence of international and national standards. For IAASB's structure and mission, see *About the IAASB*, INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD (IAASB), https://www.iaasb.org/about-iaasb.

239. FASB Accounting Standards Update, *supra* note 238. For the PCAOB GCW standards, see PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, AUDITING STANDARDS (AS) 2415: CONSIDERATION OF AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN (1989) [hereinafter PCAOB AUDITING STANDARDS]. For the similarities and differences between FASB and PCAOB standards on GCW, see Brian Daugherty, Carol Callaway Dee, Denise Dickins & Julia Higgs, *The Terminology of Going Concern Standards*, 86 CPA J. 34 (2016); Kayla D. Booker & Quinton Booker, *Changes to Going Concern Disclosures*, 86 CPA J. 42 (2016); *Going Concern – A Refresher*, GAAP Update Serv., Dec. 30, 2017 at 1. For the IFAC GCW standards, see INTERNATIONAL FEDERATION OF ACCOUNTANTS, INTERNATIONAL STANDARD ON AUDITING (ISA) 570 (REVISED) GOING CONCERN (2016), https://www.ifac.org/system/files/publications/files/ISA-570-(Revised).pdf. For the U.S. Securities and Exchange Commis-

this standard, substantial doubt exists: "when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued . . . ."[240] In connection with preparing financial statements, the management will evaluate whether substantial doubt exists, without initially taking into consideration the mitigating effect of its plans that have not been fully implemented as of the financial statement issuance day.[241]

According to FASB standards, examples for adverse conditions and events that constitute substantial doubt could be as follows:

> a. Negative financial trends, for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and other adverse key financial ratios[;] b. Other indications of possible financial difficulties, for example, default on loans or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, a need to restructure debt to avoid default, noncompliance with statutory capital requirements, and a need to seek new sources or methods of financing or to dispose of substantial assets[;] c. Internal matters, for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, and a need to significantly revise operations[;] d. External matters that have occurred, for example, legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; and an uninsured or underinsured catastrophe such as a hurricane, tornado, earthquake, or flood.[242]

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sion (SEC) guidance on disclosures that it expects when a company's financial statement includes a GCO, see SEC, CODIFICATION OF FINANCIAL REPORTING POLICIES, Section 607.02.

240. FASB Accounting Standards Update, *supra* note 238, at 7.

241. *Id.* §§ 205-40-50-1–205-40-50-5.

242. *See id.* § 205-40-55-2. *See also* PCAOB AUDITING STANDARDS 2415, *supra* note 239, § 2415.06; INTERNATIONAL STANDARD ON AUDITING (ISA) 570 (REVISED) GOING CONCERN, *supra* note 239.

When substantial doubt is raised, the management will evaluate whether its plans for the next year that are intended to mitigate this doubt will succeed in alleviating it. Then, the company will disclose principal conditions or events that raise this doubt, the management's evaluation of the significance of those conditions and events, and its plans intended to mitigate or alleviate it.[243] Furthermore, if after implementing the plans substantial doubt remains, the disclosure should explicitly state the warning that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued.[244] In the proposed mechanism, a GCW is defined as this explicit disclosure in a note in the financial statements.

It is suggested that if substantial doubt no longer exists and the note is erased, the proposed law will no longer apply to this company.[245] According to FASB standards, the company will disclose how the relevant conditions or events that raised substantial doubt have been resolved.[246]

Below I discuss possible problems of using GCW for initiating the suggested mechanism and of adjusting public offering and securities trade regulations for the case of reorganization listing, as well as solutions for these problems, including further developments and adjustments of accounting standards, disclosure regulations and securities listing criteria.

IV. Applying the Reorganization without Bankruptcy Mechanism

A. *Possible Disadvantages*

The literature on GCW discusses its disadvantages.[247] Concerns are raised with regard to the management's incentive to replace an auditor who issues a going-concern disclo-

243. *See* FASB Accounting Standards Update, *supra* note 238, §§ 205-40-50-6–205-40-50-13.
244. *See id.* § 205-40-50-14.
245. *See supra* Section III.B.1.
246. *See* FASB Accounting Standards Update, *supra* note 239, § 205-40-50-14.
247. For GCW's disadvantages, see Mary Fischer, Treba Marsh & P. Douglas Brown, *Going Concern: Decision Usefulness or Harbinger Of Doom?*, 9 J. Bus. & Acct. 136, 138–41 (2016).

sure.[248] Findings show, however, that large firms do not tend to replace auditors, especially if the auditor has specialized in a company's industry,[249] and that usually, companies fail to avoid going-concern disclosure when they attempt to go opinion shopping.[250] Furthermore, findings show that independent audit committees end with much fewer auditor dismissals.[251] Therefore, a regulation that requires auditors to have specific industry skills, increases audit committees' independence, requires managers' liability for dismissals, or imposes SEC supervision could be productive.

Other concerns are the twelve-month period that may be too restrictive and miss events expected afterward. Accounting methods may be insufficiently specific and miss adverse effects such as the kind of insolvency problems experienced by Enron that misused accounting standards.[252] On these issues, the literature suggests continuing to improve the current standards.[253]

Further concerns are that warnings might become a self-fulfilling prophecy, for example, by the effect of workers' abandonment or funding difficulties.[254] In the securities markets, however, the warnings rely on public indicators that are not expected to significantly influence the firms' value. Furthermore, disclosure to employees and investors is part of the warnings' advantages, being part of the efforts under the disclosure principle of the securities markets. The proposed reorganization without bankruptcy mechanism is expected to bar any claimants and managers' profits from deviations from the APP and the threat of destruction of the firm's value and incentivize them to firmly act in the firm's interest.[255] In turn, the mechanism is expected to increase employees and inves-

248. *Id.* at 138. Findings showed negative effects of opinion shopping on GCO accuracy. *See* Heesun Chung, Catherine Heyjung Sonu, Yoonseok Zang & Jong-Hag Cho, *Opinion Shopping to Avoid a Going Concern Audit Opinion and Subsequent Audit Quality*, 38 J. PRAC. & THEORY 101 (2019).

249. Fischer, Marsh & Brown, *supra* note 247, at 139.

250. *Id.* at 137.

251. *Cf. id.* at 138.

252. *Id.* at 139.

253. *Id.*

254. *Id.* at 140.

255. *See supra* Section III.D.3.

tors' trust in management efforts and the probability of rehabilitation.

Another concern is the market's ability to efficiently perform the reorganization under the proposed mechanism and list the rehabilitated companies' new shares for trade while a GCW is pending. Findings show, however, in a similar case of IPOs with GCW, that IPOs with a warning included in their offering documents are a common practice and that warnings increase IPOs' price accuracy by reducing price revisions and underpricing.[256]

The literature also discussed GCWs' accuracy, focusing on the findings that many companies have survived twelve months without bankruptcy after the issuance of a warning (false-positive errors) or experienced a high rate of bankruptcies without warning (false-negative errors). Arguably, the firms' survival is attributed, in part, to both the probable nature of the warnings and management's reactions in the post-warning period.[257] Moreover, findings showed that even though GCWs and an alternative model using financial ratios have similar predictive power, adding the warning to the forecast best increases such power.[258] Furthermore, the suggested mechanism does not allow equity holders and management's gains from threats to destroy firm value, nor from hiding information

256. *See* Natalia Matanova, Tanja Steigner, Bingsheng Yi & Qiancheng Zheng, *Going Concern Opinions and IPO Pricing Accuracy*, 53 REV. QUANT. FIN. & ACCT. 195 (2019).

257. *See* Fischer et al., *supra* note 247, at 140–41. For example, a study conducted from 2000–2010 found that on average approximately 16% of surviving publicly traded companies have received a GCO. Furthermore, approximately 40% of companies filing for bankruptcy in the U.S. have not received a prior opinion (false-negative errors). *See* Elizabeth Carson et al., *Auditor Reporting on Going-Concern Uncertainty: A Research Synthesis*, 32 J. PRAC. & THEO. 353, 356–57 (2013). Another study found that while a prior study had found the bankruptcy rate of first-time GCO public companies is just 9% within a period of one year of the audit opinion date, 26% of the companies that received their first GCO are delisted from trade within the same period (false-positive errors). *See* Vikram Desai et al., *A Study of the Relationship Between a Going Concern Opinion and Its Financial Distress Metrics*, 14 J. EMERGING TECH. ACCT. 1, 25 (2017). It was found that approximately 40% of the companies that received their first-time GCO survived for more than five years. *Id.*

258. *See* Elizabeth F. Gutierrez et al., *Are Going Concern Opinions Incrementally Informative Over Default Models?* 34 (November 26, 2019) (Working Paper), https://ssrn.com/abstract=2910604.

about the firm's condition that may prevent auditors from issuing the warning, at least in time. The mechanism is triggered even when bankruptcy comes at a surprise, and the managers immediately lose reputation and their position due to their misbehavior. If it turns out, however, that the rate of negative-false errors is still too high, the regulators may consider broadening the scope of events that trigger the proposed mechanism or toughening disclosure duties. For example, the mechanism may be triggered by a GCO disclosing substantial doubt, even if after implementing the management's plans substantial doubt does not remain, and the auditors' opinion does not include an explicit warning.[259]

Moreover, even evidence on this issue is mixed, as findings usually show that Big 4 auditors are more likely to issue accurate warnings (free of false-positive errors).[260] This indicates that better facilities and processes create more accurate warnings, giving rise to the claim that an effort to further develop accounting standards and processes is expected to be fruitful.[261] Regulation that improves disclosure and further increases GCW accuracy, including managers and auditors' liability, and PCAOB and SEC supervision, could be considered.

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259. See Section III.D.3. for a definition of GCW under the proposed mechanism.

260. *See* Fischer, Marsh & Brown, *supra* note 247, at 138. For a review of the broad literature on the relation between auditor size and going-concern reporting, see Nathan R. Berglund et al., *Auditor Size and Going Concern Reporting*, 37 J. PRAC. & THEO. 2, 3–5 (2018). For example, a research suggested that external auditors have significant positive influence on annual report textual disclosures, followed by CFOs and then CEOs, and that changing from a lower to higher quality auditor is associated with greater changes in disclosures. *See* Keith Czerney & Padmakumar Sivadasan, *The Relative Influences of Officers and Auditors on Annual Report Textual Disclosures* 24–25, 33 (January 2021) (Working Paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3376040.

261. Note that no significant literature has empirically examined the changes resulting from the amended accounting standard, covering going-concern issues effective for financial statements ending after December 15, 2016; however, general discussions about research and improvement of the GCO standards are found throughout a variety of written works. *See, e.g.*, Fischer, Marsh & Brown, *supra* note 247, at 137–42; Desai et al., *supra* note 257, at 25; Jan Woudenberg et al., *Company Management's and Auditor's Reporting on Going Concern: Discussion of the Current International Regulatory Framework*, 9 INT'L J. ACCT. & FIN. REP. 335 (2019).

B. *Implications for Further Research and Regulation*

1. *Extending and Shortening the Rehabilitation Period*

A possible implication of untying the Gordian knot that binds together the allocation and reallocation processes in bankruptcy is the possibility of adding to the proposed law another component, by which if an explicit warning is reissued in the following financial statements, the twelve-month rehabilitation period will begin again. Adding this component can be considered because as long as the company is solvent and there are no allocation disputes, a mechanism for company reorganization can work effectively. Furthermore, if the law allows for an extension that the claimants do not approve, the latter can use the exercise notice tool (included in Sections 2(a)–(b) of the proposed law) that enables the classes to purchase the reorganized company. The same applies to cases of sudden collapse.

For the claimants to make informed decisions as to when the reorganization plan is executed, the rules should require managers and accountants to indicate with each warning the period by which the company is expected to become insolvent. Such a rule is also necessary for considering the additional mechanism's component by which, if an explicit warning is reissued in the following financial statements, the effective day will be postponed or brought forward, as the case may be.

2. *Adjusted Securities Regulations and Listing Requirements*

Securities regulations aspects should be considered. For example, the law should clarify the requirements of the reorganization plan's prospectus, the requirements and documents for listing unregistered debt for trade before the effective day, and special listing requirements for the new shares.

If there is concern that exercising the options may create a controlling block of shares held by a potential equity holder and in turn will give her a value higher than her original rights[262] or create a marketability problem,[263] within the framework of the rules for distributing the new shares among the public, a mandatory sale of some of these shares may be considered.

262. *See* Bebchuk I, *supra* note 1, at 803.
263. *See* Roe, *supra* note 10, at 575–76.

3. *Other Complementary Regulations*

The proposed mechanism's commencement using a GCW requires examining whether special rules are needed for its formulation and contents, including specifying the length of the period until the expected insolvency. Rules that require disclosure of the amount of the company's unsecured and secured financial liabilities—for example, by the financial statements—are necessary. Other complementary rules could be considered, for example, special rules for the case of a global crisis and mass torts.

CONCLUSION

The Gordian knot theory suggests that it is impossible to attain the legislative objectives of maximizing the firm's value and dividing it according to the claimants' legal priorities by determining the firm's value efficiently, while leaving allocation problems of bankruptcy proceedings to bargaining and litigation. This understanding may be the reason why some literature and in many cases the courts are giving up on formal reorganization. The answer may be to implement the reorganization plan before bankruptcy, as proposed by the reorganization without bankruptcy mechanism.