Debtor Incentives, Agency Costs and Voting Theory in Chapter 11

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Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11

Scott F. Norberg*

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I. INTRODUCTION

The critical problem in Chapter 11 bankruptcy is the problem of “other people’s money” or, in the lexicon of economic theory, of the “agency costs” that arise when the managers of a business will not reap the full benefit or incur the full detriment of their decisions. In Chapter 11, debtors’ prebankruptcy managers generally remain in control of the business after filing. These managers in most cases are also the primary shareholders of the business. They may have little to lose and much to gain by continuing the business, attempting to reorganize and avoid the inevitable demise even as the value of the business erodes and professional fees and other costs mount.²

In the normal nonbankruptcy operation of a corporation, a combination of contractual terms, legal rules, and market conditions act to limit the moral hazard that exists when managers have interests that do not

1. Agency costs include the costs of monitoring managers, the costs of bonding by these agents, and the losses that result from the “divergence between the agent’s decisions and those decisions which would maximize the welfare of the principal.” Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 308 (1976) (footnote omitted).

2. A shareholder of the debtor in In re Kendavis Indus. Int’l, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988), was unusually candid when he stated that “there is no shareholder equity—so we’ve got nothing to lose [sic]. The banks have it all on the line now—not us.” Id. at 765 (addendum).
coincide with the interests of the firm's owners. One important limitation on the hazard is the shareholders' right to vote in corporate affairs. When a corporation files for relief under Chapter 11, bankruptcy law replaces the normal regime of limitations with the debtor in possession (DIP) system, which fails to adequately constrain the DIP's authority, permitting the DIP to act in ways that decrease instead of maximize the value of firm assets. In particular, Chapter 11 replaces the state law voting regime with a markedly different franchise procedure.

The voting rules in Chapter 11 are central to the Code scheme for confirming a plan of reorganization. Yet, while the literature includes numerous proposals for addressing the moral hazard of DIP management in Chapter 11, it almost completely ignores the relationship between

3. In general, a moral hazard problem arises whenever an actor can undertake risky behavior without fear of loss because the loss will fall on others. See Richard A. Posner, Economic Analysis of Law 181-82 (5th ed. 1998).


5. See, e.g., Edward S. Adams, Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results, 73 B.U. L. Rev. 581 (1993) (advocating appointment of a trustee in all Chapter 11 cases to make "Fundamental Bankruptcy Decisions" and a methodology for the trustee to determine whether the debtor should be reorganized or liquidated); Douglas G. Baird, Revisiting Auctions in Chapter 11, 36 J.L. & Econ. 633 (1993) (arguing that upon bankruptcy large, publicly traded companies should be put on the auction block); Lucian Arye Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775 (1988) (proposing cancellation of equity interests unless shareholders pay their pro rata share of the corporation's debts); James W. Bowers, Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure, 88 Mich. L. Rev. 2097 (1990) (calling for repeal of Chapter 11); Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 Yale L.J. 1043 (1992) (arguing that shareholders' interests should be automatically canceled upon bankruptcy, whereupon the next highest class of claimants would become the equity class); Carlos J. Cuevas, The Myth of Fiduciary Duties in Corporate Reorganization Cases, 73 Notre Dame L. Rev. 385 (1998) (advocating amendment of Chapter 11 to ensure that unsecured creditors can enforce DIP's fiduciary duties); Christopher W. Frost, Running the Asylum: Governance Problems in Bankruptcy Reorganizations, 34 Ariz. L. Rev. 89 (1992) (recommending a "shift in attitude" whereby courts would be more sensitive to the insufficiency of the limitations on management in Chapter 11 and the need to look to the wishes of the parties most directly affected by a proposed transaction); Lynn M. LoPucki, The Trouble with Chapter 11, 1993 Wis. L. Rev. 729 (proposing several procedural revisions of Chapter 11, including adoption of a separate reorganization procedure for smaller debtors, preemptive cramdown of "underwater" equity interests, and limitation of exclusivity in larger cases); Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy, 71 Tex. L. Rev. 51 (1992) (proposing that the owners of a firm be allowed to choose from a menu of bankruptcy regimes at the time the firm is formed). See generally David A. Skeel, Jr., Markets, Courts, and the Brave New World of Bankruptcy Theory, 1993 Wis. L. Rev. 465 (summarizing and criticizing several of the various proposals for reforming Chapter 11 that have been offered in response to the agency costs problem of DIP management, and proposing a separate reorganization provision for small business debtors).

In their seminal article, Bargaining After the Fall and the Contours of the Absolute Priority Rule, Professors Baird and Jackson criticized the rule of Boyd v. Northern Pacific Railway, 28 U.S. 482
agency costs and the Chapter 11 voting rules. The notable and important exception is an article by Professor David Skeel,⁶ who concludes that the voting regime in Chapter 11 is only superficially different from the system of voting under state law and that the bankruptcy franchise operates to limit agency costs of DIP control.⁷ In fact, there are fundamental and significant differences between the state law voting regime and the Chapter 11 franchise. Principally, notwithstanding the conventional wisdom, the Chapter 11 voting rules exacerbate instead of restrict agency costs.

This Article begins by reviewing the agency costs that arise in firms outside of bankruptcy and the web of limitations on these costs. In particular, the Article examines how the state law voting regime affects managers’ incentives to maximize the value of a firm. Under state law, shareholders generally hold the exclusive right to vote and exercise their right to vote by electing directors and approving fundamental corporate changes. In Chapter 11 bankruptcy, this regime is replaced by a system that gives the right to vote to most claim and equity holders and mandates a single vote on the plan of reorganization. While the state law regime gives voting authority to the group that has the appropriate incentives to maximize the value of the firm, the bankruptcy vote is intended only to determine the allocation of the value of the firm among the various claim and interest holders. One provision of the present Bankruptcy Code,⁸ section 1129(a)(10), is best understood as an attempt to limit agency costs by requiring approval of the plan by the class of

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⁷ See id. at 462-63.
creditors with the appropriate incentives to maximize the value of the firm. The courts have misunderstood and misapplied this section, however, so it has not served as an effective constraint on Chapter 11 agency costs. In fact, commentators have called for repeal of section 1129(a)(10). The Article concludes that the Code should be revised to effectively require approval of a plan of reorganization by the claim or interest holders with the appropriate incentives to maximize the value of the firm, just as shareholders in solvent corporations outside of bankruptcy hold ultimate authority over operation of the business.

II. AGENCY COSTS AND SHAREHOLDER VOTING OUTSIDE OF BANKRUPTCY

Parts III and IV of this Article will examine the nature of agency costs in Chapter 11, the limits that the DIP system places on these agency costs, and the relationship between the agency costs of DIP management and the voting regime in Chapter 11. As a predicate to that discussion, this Part reviews the nature of agency costs, and the legal, contractual, and market mechanisms that operate to limit these costs in corporations outside of bankruptcy. Readers familiar with agency cost theory may safely skip to Part III.

The nature of agency costs and the limitations on them differ depending on whether the firm is widely or closely held and on whether it is solvent or insolvent. In widely held corporations where the managers are not significant shareholders, the separation of residual ownership and control of the firm creates agency costs. In addition, the presence of debt in the capital structure of such corporations may impose further agency costs.
costs on the operation of the firm. In closely held companies where the managers are the major shareholders, agency costs stem primarily from debt in the capital structure. The nature of these two sources of agency costs in firms outside of bankruptcy, and the relationship between agency costs and the state law voting regime, are a logical starting point for analyzing the Chapter 11 franchise.

A. The Firm as a "Nexus of Contracts"

Modern corporation law theory regards the firm as a "nexus of contracts," that is, as the central party to a collection of contracts with shareholders, managers, employees, creditors, and suppliers by which the means of production are coordinated. This contractarian view of the firm reduces the distinction between shareholders and creditors by casting both as "owners" of the firm with certain rights of control over the firm's decisions, albeit with different contractual rights respecting the income and assets of the firm. Thus, while creditors' contracts with the corporation give them fixed rights to payment, shareholders' contracts entitle the shareholders to the residual value of the firm. Under the contractarian view, state corporation laws are generally understood as default rules of contract law that govern in the absence of contrary agreement among the various parties.

The principal insight of the "nexus of contracts" perspective is that the divergent interests of managers, shareholders, and creditors—each of whom is assumed to pursue his own utility—impose agency costs on the operation of the firm. Managers act as agents of the firm's owners, with primary responsibility for making investment (asset deployment)


The corporate form of business organization allows people to realize benefits from the division of labor; it permits skilled managers, who may not have the capital to finance a venture, and shareholders, who may lack the skills to operate the venture, to collaborate in a business that will increase the wealth of both. See, e.g., John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 17-20 (1986). This specialization of inputs also permits investors to diversify their portfolios, thereby reducing risk and encouraging investment. See id.

13. See Fama, supra note 12, at 290; Jensen & Meckling, supra note 1, at 312-23. Accordingly, as used in this Article, the term "owners" includes all entities with a claim or interest in a firm—shareholders with equity interests as well as creditors holding claims against the corporation. See Baird & Jackson, supra note 11, at 100-06 & n.15 ("By 'investor' (or 'owner'), we mean anyone with rights, however contingent, to the debtor's assets under nonbankruptcy law.").


15. See Jensen & Meckling, supra note 1, at 311.
decisions, yet have interests that may differ from those of the firm’s various owners.  

B. The Agency Costs of Separation of Equity Ownership and Control

In widely held corporations, the divergence of interests among shareholders and managers imposes costs on the firm when the managers (1) arrogate perquisites that lessen the value of the firm, and (2) fail to seek or take opportunities that would maximize the value of the firm but are viewed as too risky by management. The managers may own some of the firm’s stock, but their holdings generally represent a very small proportion of the total shares. Thus, the managers may share only a small fraction of any gains or losses that will result from their decisions. Managers have an interest in their own utility—preserving and enhancing their own positions and reputations. The risk of unemployment is not easily diversified, so managers will avoid financial distress of the firm that might lead to loss of employment, even though an investment decision would maximize the firm’s value.

To illustrate, consider a publicly held firm with assets valued at $100 and debt totaling $75. Assume a business opportunity that presents a 50/50 chance of success. If the investment is successful, the firm will net $50. If it is a failure, the firm will lose $30. This opportunity has a positive net value to the firm of $10. Nevertheless, the managers may be inclined not to pursue it because failure would render the corporation insolvent and jeopardize their employment and reputations.

C. Limits on the Agency Costs of Separation of Equity Ownership and Control

1. The Shareholder Franchise as a Limit on Agency Costs

While the separation of residual ownership and control imposes agency costs on the firm, these costs are subject to numerous constraints. Foremost is the corporate decision-making structure, which gives shareholders of a solvent firm ultimate authority over the firm’s affairs.

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16. See id. at 308-09.
17. See id. at 312-13; see also Fama, supra note 12, at 295-97.
19. If the investment is successful, the value of the firm’s assets will be $150. If unsuccessful, the value will be $70. Because the chance of success is 50/50, the projected value of the firm is ($150 + $70)/2, or $110, which is $10 more than the present value of the firm’s assets.
20. In contrast, shareholders will likely favor the investment because they are primarily interested in maximizing the value of their equity interests and are willing to countenance greater risk because they can diversify that risk with other investments. See discussion infra Part II.C.1.
They, in contrast to any other class of owners, possess the appropriate incentives (setting aside for now the collective action problem) to make decisions that maximize the value of the firm. Shareholders are the residual owners of the firm, that is, their rights to the cash flow and assets of the firm are subordinate to the rights of creditors with fixed claims. As residual risk bearers, shareholders of a solvent business stand to both reap the benefits and bear the costs of their decisions; stated differently, the potential for loss is fused with the possibility of gain.

Take, for example, a firm with assets valued at $100 and debt totaling $75. Assume that the firm is presented with an investment opportunity with a 50/50 chance of netting $15 or losing $10. The shareholders have the best incentives regarding this decision because they will enjoy the full benefit as well as suffer the full loss that may result from deploying the firm’s assets to take advantage of this opportunity. If the investment is successful, the shareholders will enjoy the entire benefit; their equity interest will increase in value from $25 to $40. If unsuccessful, the shareholders’ interest will decrease from $25 to $15. In contrast, creditors may be largely indifferent, if not adverse, to the investment because it might decrease the size of the equity cushion.

The role of shareholders in corporate decision making varies depending on whether the firm is widely or closely held. The essential components of corporate decision making are identification and initiation of proposals, ratification of decision initiatives, implementation of ratified decisions, and monitoring of decision agents. Initiation and implementation decisions are typically performed by the same agents—the managers of the business. The ratification and monitoring functions are also typically performed by the same agents—either the managers or the shareholders and directors, depending on whether the firm is closely or widely held. It has been demonstrated that when residual risk bearing is separated from the initiation and implementation (management) functions, the management functions are separated from the ratification and monitoring (control) functions. Thus, in widely held corporations in which the residual risk bearers (the shareholders) do not manage the firm, the management and control functions are clearly divided between the managers, on the one hand, and the board of directors and sharehold-

21. The collective action problem is discussed infra note 41 and accompanying text.
22. See Easterbrook & Fischel, supra note 14, at 403.
23. See id. at 403-06; Fama, supra note 12, at 290-91; Fama & Jensen, supra note 12, at 302-03; Jensen & Meckling, supra note 1, at 312-13.
25. See id.
26. See id.
27. See id. at 304-11.
ers on the other. Conversely, the combination of management and control authority in a few agents typically occurs when residual claims are held by those same agents. In close corporations, the managers are also the principal shareholders and exercise authority over both management and control decisions.

In widely held corporations, shareholders exercise their ratification and monitoring (control) functions through the shareholder franchise. The right to vote is the right to make all of the myriad corporate decisions that are not and cannot efficiently be otherwise specified by contract or legal rule. Shareholders generally elect directors and delegate most of their authority to make unspecified decisions to the directors, who in turn elect or appoint officers to manage the business. At the same time, shareholders retain authority to remove managers at any time and to approve charter amendments and fundamental corporate changes—mergers, acquisitions, and sales of a substantial portion of firm assets. When a corporation has more than one class of shares, changes to the rights of the shareholders in one of the classes must be approved by a majority vote of both the affected class and all shareholders.

In addition to explaining that shareholders generally hold the right to vote because they hold the appropriate incentives to maximize the welfare

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28. See id. at 307-11.
29. See id. at 305-07.
30. See id.
31. See Easterbrook & Fischel, supra note 14, at 403-06. Easterbrook and Fischel were the first writers to examine the relationship between agency costs and corporate voting. This Part draws heavily on their work. They note the right to vote is an aspect of the web of contracts that comprise a firm. See id. at 401. A firm's contracts with shareholders (the corporate charter and by-laws), creditors (loan and other credit agreements), and managers and employees (employment contracts) govern operation of the business. See id. Further, legally prescribed "default rules"—contract terms supplied by corporate law that apply in the absence of contrary agreement by the parties (and which thereby reduce costs of contracting when the default rules meet the parties' needs) supplement express contractual terms. See id. at 401-03. In addition, the fiduciary standard governs the conduct of officers and directors. See id. at 402. Contract provisions, default rules, and the fiduciary principle, however, "cover only the outlines of the relations among corporate actors." Id. Of necessity, many decisions about the conduct of the business will not be specified by contract or applicable law. See id. at 401-03.
32. See, e.g., REV. MODEL BUS. CORP. ACT § 8.01(a) (1991) ("Except as provided in [a shareholder agreement], each corporation must have a board of directors.").
33. See id. § 8.40.
34. See id. § 8.08(a). This authority is sometimes limited by employment contract provisions that make it prohibitively expensive to fire managers.
35. See id. §§ 10.03, 10.20.
36. See id. §§ 11.03, 12.02. Corporate laws generally require approval by a majority of all shares, not simply a majority of shares voting, for fundamental corporate changes. See id. §§ 10.03(e), 11.03(b)(2), 12.02(b)(2).
37. See id. §§ 10.03, 10.04.
agency cost analysis also explains why the right to vote is almost invariably limited to shareholders alone. Including other constituencies would introduce agency costs by permitting persons who do not stand to realize the marginal benefits and losses of their decisions to affect firm decisions. Likewise, the rules and practices that assign one vote per share ensure that each shareholder holds the appropriate incentives to make efficient corporate decisions. Cumulative voting and vote selling introduce agency costs by creating an asymmetry between voting power and economic consequences.

While the justification for the shareholder franchise may be clear—that shareholders hold the appropriate incentives to maximize the wealth of the firm—the efficacy of corporate voting is open to question. Traditional corporate law theory viewed the shareholder franchise as virtually meaningless in widely held corporations because the collective action problem precludes effective exercise of the franchise. The Wall Street Rule, which states that a dissatisfied shareholder's recourse is to sell her shares, was seen as the only real protection for investors against poor management.

More recently, Fischel and Easterbrook have challenged the traditional wisdom. They persuasively argue that the right to vote has considerable utility at the margins. This utility is evidenced by the following facts: voting facilitates corporate takeovers; voting contests increase share prices; the aggregation of claims increases the value of the aggregated shares; in the unusual cases where there are classes of stock with identical rights except that one class has voting rights, the class with voting rights trades at a slightly higher price; and firms without shareholders do less well than typical corporations. Significantly, shareholder accumulation

38. See Easterbrook & Fischel, supra note 14, at 403-06. That shareholders hold the exclusive right to the franchise may, in addition, be explained on the ground that shareholders cannot safeguard against misbehavior by managers as readily as creditors and employees, who may have firm-specific investments that limit managerial discretion. See Skeel, supra note 6, at 568-72.

39. See REV. MODEL BUS. CORP. ACT § 7.22(d).

40. See Easterbrook & Fischel, supra note 14, at 403-06.

41. See ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (rev. ed. 1968). In widely held firms, the collective action problem explains the lack of shareholder involvement in the corporate democracy. Shareholders are rationally apathetic because each shareholder owns only a tiny fraction of the equity, and the costs of participating in management—reading proxy materials and voting—exceeds any possible benefit to the shareholder. This collective action problem is a rational response to the costs and benefits of participation in the corporate franchise. The collective action problem dissipates when an individual shareholder (e.g., an institutional investor) acquires a significant equity stake in a firm.

42. See Easterbrook & Fischel, supra note 14, at 406-08.

43. See id.

44. See id.
of shares lessens the collective action problem. In sum, "votes are important despite the collective action problem, and the voting process enables firms to operate more efficiently."\(^4\)

2. Other Limits on the Agency Costs of Separation of Equity Ownership and Control

In addition to the shareholder franchise, contracts between the firm and its managers (e.g., stock options, agreements tying executive compensation to corporate profits, and golden parachutes) can be used to encourage managers to take more risks and thereby reduce the agency costs of the separation of equity ownership and control. Further, the markets for the sale of stock and corporate control check agency costs by encouraging managers to maximize the value of the firm or else suffer decreases in stock value that jeopardize the managers' positions by exposing the firm to corporate takeover bids. Likewise, the managerial labor market disciplines managers. The legal rules imposing fiduciary duties of care and loyalty on the officers and directors of a corporation also act to limit agency costs.

\(^{45}\) See id. Historically such accumulation was unlikely, but more recently institutional investors have acquired substantial stakes in most public corporations, making it worthwhile for these shareholders to participate in the management of the firm. See, e.g., Paul R. Bergen, Voting By Institutional Investors on Corporate Governance Issues in the 1988 Proxy Season (1988) (noting institutional investors are continuing to increase participation in corporation governance); Charles R. O'Kelley, Jr. & Robert B. Thompson, Corporations and Other Business Associations: Cases and Materials 218 (2d ed. 1996) ("The 1990s have witnessed a surge of institutional investor participation in corporate governance . . ."); Easterbrook & Fischel, supra note 14, at 425-26 (noting increased involvement by institutional investors); John Pound, The Rise of the Political Model of Corporate Governance and Corporate Control, 68 N.Y.U. L. Rev. 1003, 1005 (1993) (underlying more active boards are institutional investors).

\(^{46}\) Easterbrook & Fischel, supra note 14, at 408.

\(^{47}\) See Adams, supra note 5, at 602; Frost, supra note 5, at 106-07; Jensen & Meckling, supra note 1, at 323-28; Rasmussen, supra note 18, at 1175-76. Of course, the costs of these arrangements are themselves agency costs.

\(^{48}\) See Adams, supra note 5, at 602-03; Frost, supra note 5, at 106-07; Jensen & Meckling, supra note 1, at 329; Rasmussen, supra note 18, at 1175-76.

\(^{49}\) See Fama, supra note 12, at 292-95; Jensen & Meckling, supra note 1, at 328.

\(^{50}\) See REV. MODEL BUS. CORP. ACT §§ 8.30, 8.42, 8.60-8.63 (1991). The duty of care generally requires officers and directors to exercise the degree of care that ordinarily prudent persons would exercise under the same or similar circumstances. See id. §§ 8.30(a), 8.42(a). The duty of loyalty requires officers and directors to refrain from self-dealing and usurping corporate opportunities. See id. §§ 8.60-8.63. These fiduciary duties imposed by law are not, of course, entirely efficacious. The business judgment rule ameliorates the requirements of the duty of care by establishing a presumption that directors have fulfilled the duty; most courts hold that directors are not personally liable for breach of the duty of care in the absence of gross negligence. See generally 1 James D. Cox et al., Corporations § 10.2 (1995). Further, it is not entirely clear to whom the duties of care and loyalty are owed. The Revised Model Business Corporation Act states the duties
D. The Agency Costs of Debt

It is well recognized that the capital structure of a firm influences managers' decision making.51 While the shareholders of a solvent corporation generally share both the possibility of future gain and the are owed to the corporation, but the interests of the corporation depend largely on what group constitutes the residual ownership class. See the discussion infra notes 69-70 and accompanying text, regarding the shift in management fiduciary duties upon insolvency of the corporation.

51. While equity is necessarily a component of the capital structure, debt is not. The use of some debt is considered efficient, but the optimal mix of debt (and of various types of debt) and equity is the subject of considerable debate. See, e.g., VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 372 (3d ed. 1987) ("One of the most widely debated issues in financial theory continues to be whether the value of the corporate enterprise can be enhanced by a judicious use of leverage, i.e. by financing corporate investments with senior securities as well as common shares."); Michael Bradley et al., On the Existence of an Optimal Capital Structure: Theory and Evidence, 39 J. FIN. 857, 857 (1984) ("One of the most contentious issues in the theory of finance during the past quarter century has been the theory of capital structure."); George G. Triantis, Debt Financing, Corporate Decision Making, and Security Design, 26 CAN. BUS. L.J. 93, 94-97 (1996) ("The fixed obligations of debt are a source of discipline on managers that requires minimal monitoring."). The use of debt increases the potential return on investment to the equity holders while simultaneously increasing the risk of the investment. See Charles W. Adams, An Economic Justification for Corporate Reorganizations, 20 HOFSTRA L. REV. 117, 119 (1991) (citing BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 539-50 (4th ed. 1962)). Adams poses this example:

Consider, for example, an investment that has a 50/50 probability of returning either $50,000 or $150,000, so that the expected return is $100,000. If $1,000,000 of capital is needed for this investment and this capital is provided entirely by equity, then the investment would yield an expected rate of return of ten percent. The expected rate of return for equity holders would increase substantially if $900,000 of the capital came from debt paying nine percent interest, and the remaining $100,000 came from equity. The expected return for equity would then be $19,000 (obtained by subtracting interest to debt holders of $81,000 from the expected return before interest of $100,000), and the expected rate of return for the $100,000 of equity would be nineteen percent. With the introduction of debt, the expected rate of return for equity has nearly doubled. At the same time, the riskiness of the equity investment has increased dramatically because the expected return, after interest payments of $19,000, is the average of a 50/50 probability of either a $31,000 loss, or a $69,000 profit on the $100,000 equity investment. The use of debt for capital financing both dramatically improves the rate of return for shareholders and exposes their investment to increased risk.

Id. at 119-20 (footnotes omitted).

In large, widely held corporations, the capital structure often is complicated with many levels and types of debt and equity. For example, debt might include institutional secured debt, public secured debt (bonds), subordinated and unsubordinated debentures, unsecured institutional debt and unsecured trade debt, and the equity interests may include various levels of preferred and common stock. The capital structure of most small, closely held businesses is comparatively simple: the firm has a primary secured creditor who holds a security interest in virtually all of the firm's assets; trade creditors whose claims are relatively small in relation to the secured debt; and one or several equity holders who also manage the firm. See Douglas G. Baird, The Reorganization of Closely Held Firms and the "Opt Out" Problem, 72 WASH. U. L.Q. 913, 920-24 (1994); Samuel L. Bufford, What Is Right About Bankruptcy Law and Wrong About Its Critics, 72 WASH. U. L.Q. 829, 835 (1994).
potential for future loss, these prospects are not symmetrical when the capital structure includes debt. Shareholders hold unlimited upside potential, but limited downside risk by reason of the limited liability rule.52 In contrast, debt holders have fixed claims and may recover no more than the amount of those claims. These divergent interests of debt and equity holders may impose agency costs on the operation of the firm.53

While shareholders generally hold the appropriate incentives to maximize the welfare of the firm, their authority over all unspecified decisions presents the clear possibility that they will exploit their conflicts with debt holders to the detriment of the firm.54 In the case of a solvent firm, shareholders have an interest in pursuing profitable investments. However, they sometimes will also find it profitable to pursue opportunities with a negative value because they will reap the benefits but not suffer all losses from the investment.55 Consider, for example, a firm with assets of $100 and debt totaling $90. The firm has a business opportunity that will require a $100 investment and has a 50/50 chance of producing a gain of $60 or a loss of $100. This investment has a negative net value of $20. Yet, the shareholders will tend to favor the investment because it increases the value of their equity from $10 to $35. In other words, the shareholders would enjoy the entire benefit if the investment is successful, but suffer only $10 of the $100 loss if it is unsuccessful. The creditors of course will disfavor the investment because they stand to gain nothing more than an enhanced equity cushion, but risk a complete loss. Thus, a firm will incur agency costs to the extent that the presence of debt in the capital structure causes its managers to make overly risky, negative net present value investments.

E. Limits on the Agency Costs of Debt

The agency costs of debt are circumscribed in several ways. As an initial matter, creditors may attempt to limit managerial discretion through their contracts with the firm, for example, by contracting for a large equity cushion, prohibiting further encumbrances on assets of the firm, requiring approval for the issuance of new debt, or making impairment

52. As discussed infra, Part II.E., the shareholder-managers of closely held firms often are guarantors of much of the firm’s debt and, thus as a practical matter, are not protected by the limited liability rule.
53. See Jensen & Meckling, supra note 1, at 333-43; Rasmussen, supra note 18, at 1167-73. In close corporations, the managers are the equity owners, and the impact of the capital structure on manager decision making is direct. In widely held corporations, the effects are mediated by the presence of the non-owner managers.
54. See Jensen & Meckling, supra note 1, at 334-37.
55. See id. at 333-43; Rasmussen, supra note 18, at 1167-73.
of the expectation of repayment an event of default. In addition, creditors of closely held firms often require the principals to guarantee their debts. Guarantees align the managers’ interests with the interests of creditors and thus may reduce the agency costs of debt by ensuring that the managers will experience the losses that may result from their decisions. Of course, guarantees do not perfectly align managers’ interests with the creditors’ interests. The manager-guarantors maintain interests of their own. Whereas creditors are generally diversified in their credit risks, managers cannot diversify against the risk of unemployment. Further, the individual managers’ option to file bankruptcy and seek a discharge of their obligations means that they do not assume the entire risk of their decisions.  

F. Agency Costs and Insolvency

Insolvency, which is the financial condition of almost all Chapter 11 debtors, dramatically increases the potential agency costs of debt. Upon insolvency, creditors replace shareholders as residual owners of the firm. Like the shareholders of a solvent firm, the residual creditors of an insolvent firm hold both the potential for gain and the possibility of loss from investment decisions and, therefore, have the appropriate incentives to maximize the value of the firm. In contrast, shareholders of an insolvent firm may profit from firm investments, but have nothing to lose. While liquidation of the firm may be in the best interests of creditors, shareholders have nothing to gain from it. Just when the need

56. An individual debtor whose debts are not primarily consumer debts may receive a Chapter 7 discharge even though she could pay all or most of her debts from future income. See 11 U.S.C. § 707(b) (1994) (requiring dismissal when a case would be a "substantial abuse" of the provisions of Chapter 7). The most important, if not exclusive, consideration in whether a filing constitutes a "substantial abuse" of Chapter 7 is whether the debtor whose debts are primarily consumer debts could repay a significant portion of her debts from future income. See, e.g., In re Walton, 866 F.2d 981, 984-85 (8th Cir. 1989). Section 707(b) apparently exempts debtors whose debts are not primarily consumer debts from dismissal of their cases for "substantial abuse" precisely because Congress did not want to discourage entrepreneurial risk.

57. "Insolvency" does not refer to bankruptcy. "Insolvency" means a financial condition such that the sum of all debts exceeds the value of all assets of the firm. See 11 U.S.C. § 101(32)(A).


59. See id. at 666-67.

60. See id. There is, however, an important difference between the residual ownership interest held by the shareholders in a solvent firm and the residual ownership interest of creditors of an insolvent firm. As long as the firm continues to operate, shareholders of an insolvent firm may be seen as having some residual ownership interest because their interests might obtain value if the fortunes of the firm sufficiently improve. In contrast, creditors with fixed claims stand to benefit from investment decisions only up to the amount of their claims.

61. See id.
for effective control (ratification and monitoring)\textsuperscript{62} of managers' decisions is most acute—when the firm is on the verge of collapse—shareholders lose the appropriate incentives to make efficient decisions.

Yet, upon insolvency the same managers continue to manage the firm and shareholders almost always retain their authority. As a result, closely held firms where the managers are also the major shareholders confront not only the agency costs of debt, but also the agency costs of the separation of residual ownership and control. Significantly, even though risk bearing is not aligned with decision management in these firms, decision management is not separated from decision control. Unlike managers in a solvent widely held firm who act subject to the control authority of the residual owners, the shareholder-managers of an insolvent closely held firm exercise both management and control authority.\textsuperscript{63}

In insolvent widely held corporations, managers who are primarily interested in their employment and reputations may be inclined toward overly risky investment decisions, so as to reverse the firm's fortunes. Insolvency encourages previously risk-averse managers to take unwarranted risks in order to turn around the company and save their job positions and reputations.\textsuperscript{64}

Managers of insolvent firms will have incentives to pursue investment strategies without regard to risk, with the strategy depending on the options and the degree of the firm's insolvency. As in the case of the solvent firm, the managers of an insolvent firm may pursue investments that have no value for the firm but which benefit the equity holders. Thus, assume a firm has assets of $100 and debt totaling $140. Further assume an investment opportunity with a 50/50 chance of yielding a net gain of $80 or a net loss of $0. This investment has a negative net value to the firm (-$10), but increases the value of the shareholders' equity from (-$40) to $0.

Under different circumstances the shareholders may have incentives to underinvest. Assume a firm with assets worth $90 and debt totaling $120. Assume further a business opportunity that has a 50/50 chance of a net $15 gain or a $5 loss, so that the opportunity has a net present value of $5. Although this investment would increase the value of the firm, the equity holders may not have the incentives to seek or take this opportunity because it will not yield any value to their interests. The residual claim holders obviously would favor it. Thus, equity holders may tend to bypass valuable opportunities when they are not expected,

\textsuperscript{62} See supra notes 24-30 and accompanying text (discussing the corporate decision-making process and the division of decision-making authority between managers and residual owners).

\textsuperscript{63} See supra notes 24-30 and accompanying text.

\textsuperscript{64} See Rasmussen, supra note 18, at 1174.
alone or in combination with other investments, to yield any value for the equity class. 65

G. Limits on Agency Costs in Insolvent Firms

While residual owner suffrage is rare in insolvent businesses, 66 other constraints on agency costs give creditors authority over an insolvent firm that is comparable to the authority held by shareholders in solvent firms. 67 Most significantly, creditors' contracts with the firm may impose restrictions upon managers' discretion to operate the firm in the event it encounters financial difficulty. Contracts often provide that insecurity concerning repayment of a debt is grounds for declaring a default. Upon the debtor's default (when the firm typically is insolvent and creditors have become the residual risk bearers), the creditor (either secured or unsecured holding a judgment) acquires the right to seize assets of the firm. This right gives the creditor leverage to restrict managers' decision making. Along similar lines, the corporate charters of some widely held firms provide that upon insolvency bondholders acquire the right to vote and thereby the control of managerial decision making. In addition, as noted above, personal guarantees of the corporate managers would constrain agency costs by imposing upon managers the risks of their investment decisions. 68

In addition to contractual constraints on agency costs associated with insolvency, the state law fiduciary obligations owed by officers and directors to shareholders 69 are extended to include creditors when the firm becomes insolvent, because creditors become the residual owners and equity holders lose the appropriate incentives to maximize the value of the firm. 70 The officers and directors of an insolvent firm face potential

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65. The underinvestment problem should not be overstated. Over time the firm will encounter multiple opportunities that together might yield value to the equity interests. See Rasmussen, supra note 18, at 1171-72.

66. Except in the infrequent instances when bondholders of financially distressed firms acquire the right to vote, a residual owner franchise is not a limitation on the agency costs that may arise upon insolvency.

67. Cf. Easterbrook & Fischel, supra note 14, at 404 ("The right to vote (that is, the right to exercise discretion) follows the residual claim. . . . When the firm is insolvent, the . . . creditors eventually acquire control . . . ").

68. See supra Part II.E.

69. See supra note 50 and accompanying text.

liability for management decisions that disregard the interests of the creditors in favor of the shareholders.

Finally, with respect to insolvent firms, state laws proscribe fraudulent transfers, preferences to insiders, and dividend payments to equity holders. These laws permit creditors to avoid transfers or obligations that benefit manager-shareholders at the expense of the firm's creditors.

III. AGENCY COSTS AND THE DEBTOR IN POSSESSION SYSTEM IN CHAPTER 11

Chapter 11 addresses two fundamental issues. The first concerns deployment of the debtor's assets. The need for relief under the Bankruptcy Code arises when a firm is unable to pay its debts. While inability to pay debts frequently indicates that the debtor's use of its assets is not efficient, the advisability of redeploying assets (i.e., liquidating them) does not necessarily follow from the fact of financial crisis. A firm with income insufficient to cover both the costs of production and debt service may be using its assets efficiently if income derived from the assets exceeds costs of production.

Chapter 11 also addresses the critical issue of how the value of the firm should be allocated among the various claim and equity holders. The allocation question is largely governed by the absolute priority rule, which states that no junior claim or interest may receive any distribution of firm assets unless all senior claims and interests are paid in full. In Chapter 11, a plan may propose to deviate from the absolute priority rule if the adversely affected classes of claim and interest holders consent;

1992); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). The efficacy of fiduciary duties to creditors, however, is undermined significantly by the business judgment rule and by the difficulties in measuring the point of insolvency. Liability of officers or directors for breach of any fiduciary duty to creditors has been reserved for the most egregious cases.

71. See, e.g., UNIF. FRAUDULENT TRANSFER ACT §§ 4, 5(a) (1985).
72. See, e.g., id. § 5(b).
75. See id. A business is viable when income exceeds the costs of production, although the net income may be insufficient to pay debts. A business is not viable when the present liquidation value is greater than the present value of the future net operating income. See Lynn M. LoPucki, A General Theory of the Dynamics of the State Remedies/Bankruptcy System, 1982 WIS. L. REV. 311, 325-27.
76. See JACKSON, supra note 74, at 210-13.
compliance with the absolute priority rule is subject to negotiation among the debtor, creditors, and equity holders.78

The prebankruptcy managers of a firm generally continue to operate the firm after the Chapter 11 filing. As the DIP, the managers are responsible for the “management” functions79 of initiating and implementing deployment and allocation decisions. At the same time, these managers are subject to the same conflicts of interest that arise among owners and managers outside of bankruptcy. Thus, the managers of an insolvent firm in Chapter 11 naturally favor reorganization and delay, and they are prone to overly risky or risk-averse decisions.80 They will avoid liquidation because it would put them out of a job and irrevocably terminate their equity stakes. The residual owners—who are creditors when the business is insolvent—do not, however, hold authority over control decisions81 that is equivalent to the control held by residual owners outside of bankruptcy.82 The ratification and monitoring functions of the residual risk bearers outside of bankruptcy83 are displaced by the DIP system in Chapter 11, which fails to adequately limit the agency costs that arise in an insolvent firm.

A. DIP Authority in Chapter 11

The Bankruptcy Code provides that the debtor shall continue to manage the firm after filing for relief under Chapter 11,84 unless the court orders appointment of a trustee.85 As manager of the business, the DIP faces two basic types of deployment and allocation decisions: “business plan” decisions and “reorganization plan” decisions.86 The business plan

78. See id. § 1129(a)(8), (b). While liquidation entails a market sale of assets to third parties, reorganization is in effect a sale of assets to the existing claimants. In a reorganization, existing claimants become the owners of the reorganized debtor in exchange for releasing their prebankruptcy claims. See, e.g., JACKSON, supra note 74, at 210-11; Robert K. Rasmussen & David A. Skeel, Jr., The Economic Analysis of Corporate Bankruptcy Law, 3 AM. BANKR. INST. L. REV. 85, 94 (1995).
79. See supra notes 24-30 and accompanying text (discussing the corporate decision-making process, and the division of decision-making authority among managers and residual risk bearers).
80. See supra notes 57-73 and accompanying text (discussing agency costs in insolvent firms).
81. See supra notes 24-30 and accompanying text (discussing the corporate decision-making process, and the allocation of decision-making authority among managers and residual risk bearers).
82. Cf. Skeel, supra note 6, at 482-84.
83. See supra notes 24-30 and accompanying text (discussing the corporate decision-making process, and the allocation of decision-making authority among managers and residual risk bearers).
84. Upon filing, the debtor becomes the debtor in possession, see 11 U.S.C. § 1101(1) (1994), and the debtor in possession is authorized to operate the business. See id. §§ 1107, 1108.
85. See id. § 1104.
86. See LoPucki & Whitford, supra note 5, at 678-79; see also Adams, supra note 5, at 592-93 (stating that DIP faces three types of decisions: “Business Activity Decisions,” which involve choices concerning the use of assets and day-to-day operations; “Fundamental Bankruptcy Decisions,” which involve decisions concerning whether to reorganize or liquidate and the allocation of losses among
is the set of decisions by which the DIP seeks to restore the profitability of the business. It concerns deployment of the firm’s assets, including day-to-day operations, borrowing money, sales of assets, and assumption or rejection of executory contracts and leases. These decisions will affect the value of the firm and thus the losses that creditors will incur on their claims. The reorganization plan may also address business plan decisions. Moreover, the reorganization plan determines the capital structure of the business and the distribution of cash, stock, and other property to the claimants. Implicit in a plan of reorganization is the decision not to liquidate all of the firm’s assets.

The DIP generally possesses the exclusive right to make management decisions, that is, to initiate and implement both the business and reorganization plans. This authority is especially broad with respect to business plan decisions. The DIP may unilaterally make decisions that fall within the ordinary course of business without even disclosing its business plan to creditors or the court, much less obtaining ratification of such decisions. Further, although the DIP must obtain court approval for business plan decisions that fall outside the ordinary course of the debtor’s business, the power of initiative combines with the DIP’s information advantages and the courts’ general deference to DIP business judgments to give the DIP substantial ratification and monitoring authority in addition to its powers of initiative and implementation. With respect to the reorganization plan, the Code grants the DIP the exclusive right to file a plan for 120 days after the entry of the order for relief, which period the court may extend “for cause.” The DIP’s information advantage over claimants facilitates control over business and plan decisions. The managers have greater knowledge of business

the various claimants; and “Non-Polar Decisions,” which are a combination of Business Activity and Fundamental Bankruptcy Decisions).

87. See LoPucki & Whitford, supra note 5, at 679, 692.
88. See id. at 679.
89. See id. at 692.
90. See id.
93. See LoPucki & Whitford, supra note 5, at 692, 694. For example, courts review most decisions to assume or reject an executory contract or to sell property of the estate under a business judgment standard analogous to the business judgment rule that is applied to questions of director liability under nonbankruptcy corporate law. See, e.g., Lubrizol Enter. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1046-47 (4th Cir. 1985) (applying business judgment rule to executory contract decision); Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) (requiring a “good business reason” for a proposed sale of assets).
94. See LoPucki & Whitford, supra note 5, at 692-94.
95. See 11 U.S.C. § 1121(b), (d).
operations, control the employees who generate the information, and control access to the information.  

B. Direct Limits on the Agency Costs of DIP Management

The DIP's discretion to make business and reorganization plan decisions is constrained by a complex web of statutory and case law. The most significant limits on DIP control in Chapter 11 are (1) the fiduciary obligations owed by the DIP to creditors and equity holders, (2) the right of claimants to replace the DIP with a trustee under specified circumstances, (3) the requirements for notice and hearing on matters outside the ordinary course of the debtor's business, (4) the rights of claimants to vote on and object to the debtor's plan and to propose their own plans of reorganization, (5) the provisions for creditors' and equity holders' committees, (6) the rights of creditors to withdraw credit from the business, and (7) the bankruptcy court's power to manage its cases. As discussed in this section, these provisions have failed to adequately limit the agency costs of the DIP system.

Analogous to the fiduciary obligations of care and loyalty owed by officers and directors of solvent companies outside of bankruptcy, the Code imposes fiduciary duties on the DIP with respect to operation of the business in bankruptcy. The courts frequently state that the DIP's fiduciary duty runs to creditors. In addition, the prevailing view is that the DIP also acts as a fiduciary for the interests of the equity holders. The interests of different creditors frequently conflict with one another and with the interests of shareholders. Thus, while it is clear that the DIP is a fiduciary, the nature and extent of the DIP's obligations are uncertain and enforcement is therefore complicated. Further, the courts generally apply a business judgment standard to DIP decisions, which gives a presumption of validity to DIP decisions that is especially hard to rebut in light of the uncertain nature and extent of the fiduciary obligation. The bottom line is that the fiduciary obligations imposed by the Code do not represent a significant limitation on DIP authority. Claimants seldom

96. See LoPucki & Whitford, supra note 5, at 694.
97. See generally Adams, supra note 5, at 611-21.
98. See supra note 50 and accompanying text.
100. See LoPucki & Whitford, supra note 5, at 707-09 & nn.148-49 (collecting cases); see also Adams, supra note 5, at 611-13.
101. See LoPucki & Whitford, supra note 5, at 709.
103. See Adams, supra note 5, at 612-13 & nn.154-60 (collecting cases).
move to enforce the duties;\textsuperscript{104} seeking appointment of a trustee is a better response to DIP breaches of the fiduciary duty.\textsuperscript{105}

As a limit on DIP misbehavior, the Code provision for replacing the DIP with a trustee is also of marginal utility. Section 1104 provides that the court shall appoint a trustee to replace the DIP for "cause, including fraud, dishonesty, incompetence, or gross mismanagement," or when the appointment of a trustee is in the interests of creditors and equity holders.\textsuperscript{106} Consistent with Congressional intent,\textsuperscript{107} this remedy for DIP misbehavior is rarely invoked, primarily because the pre-bankruptcy managers are most familiar with the business and many debtor businesses could not survive the cost and disruption of bringing in a trustee. Further, in small debtor cases, the appointment of a trustee is tantamount to a decision to liquidate the business because the operation of the business depends on the first place on the shareholder-managers.

As to business plan decisions, the Code limits DIP authority by requiring court approval after notice and hearing for transactions outside the ordinary course of business.\textsuperscript{108} Thus, creditors can object and be heard on DIP decisions to use cash collateral,\textsuperscript{109} obtain credit,\textsuperscript{110} or sell assets\textsuperscript{111} other than in the ordinary course of business. Similarly, the DIP may assume or reject executory contracts and leases only with court approval after notice and hearing.\textsuperscript{112} At the same time, however, the courts generally review DIP decisions in these matters under a "business judgment" standard that gives considerable deference to the DIP.\textsuperscript{113}

As to reorganization plan decisions, the debtor's exclusive power of initiative is limited by the requirements for acceptance of the plan by claimants and approval by the court.\textsuperscript{114} As discussed in the next Part, creditors may influence reorganization plan decisions by voting and objecting to the plan, but the larger purpose of the voting rights under the current provisions of Chapter 11 is to allocate the going concern surplus—the difference between the going concern and liquidation values—of the firm and not to determine whether reorganization is a

\textsuperscript{104} See LoPucki & Whitford, supra note 5, at 709; see also Adams, supra note 5, at 612-13.
\textsuperscript{105} See LoPucki & Whitford, supra note 5, at 709-10.
\textsuperscript{108} See, e.g., 11 U.S.C. §§ 363(a), 363(c), 364, 365(a).
\textsuperscript{109} See id. § 363(c).
\textsuperscript{110} See id. § 364.
\textsuperscript{111} See id. § 363(a).
\textsuperscript{112} See id. § 365(a).
\textsuperscript{113} See Adams, supra note 5, at 612-13 & nn.154-60 (collecting cases).
\textsuperscript{114} See 11 U.S.C. §§ 1124, 1129.
better response than liquidation to the firm's financial crisis.\textsuperscript{115} A plan that fails to fully pay unsecured creditors cannot be confirmed unless (1) the plan cancels the rights of junior claimants or (2) all classes of unsecured claims vote to approve the plan by more than two-thirds in amount and one-half in number of the claims in each such class.\textsuperscript{116} Moreover, the debtor's exclusive right to file a plan expires four months after the filing of the petition, unless extended by the court "for cause," and creditors may then propose their own plans.\textsuperscript{117} As a practical matter in most smaller cases, however, it is not feasible for anyone other than the DIP to prepare a disclosure statement and propose a plan. This is because the business cannot exist independent of its shareholder-managers, and the size of individual creditor claims will not justify the expense of formulating, negotiating, and obtaining confirmation of a non-debtor plan.\textsuperscript{118} Thus, in many cases the DIP effectively holds the sole "right" to file a plan even after the exclusivity period has legally expired. In large cases, the courts routinely extend exclusivity. Because delay postpones payment of creditor claims and tends to erode the value of the business, the exclusive right to file a plan confers considerable leverage on the DIP and counteracts the creditors' rights to vote on and object to the plan.\textsuperscript{119}

In regard to both business and reorganization plan decisions, the Code calls for the appointment of an unsecured creditors' committee in all Chapter 11 cases.\textsuperscript{120} Chapter 11 also provides that the court may appoint additional creditors' committees and an equity holders' committee if necessary to "assure adequate representation of creditors or equity security holders."\textsuperscript{121} Committees may retain counsel and other professionals who will be paid from the estate, and expenses of individual committee members may likewise be reimbursed from funds of the debtor.\textsuperscript{122} Creditors' committees do not have any final decision-making authority, but they have broad rights to take part in DIP decision making\textsuperscript{123} and committee positions may be given great weight by the court. The regulation of DIP decision making by creditors' committees has proved largely ineffectual, however, in small and medium-sized

\begin{itemize}
\item \textsuperscript{115} See id.
\item \textsuperscript{116} See id. §§ 1126(c), 1129(a)(8), (b).
\item \textsuperscript{117} See id. § 1121.
\item \textsuperscript{119} See LoPucki & Whitford, supra note 5, at 693-94.
\item \textsuperscript{120} See 11 U.S.C. § 1102(a).
\item \textsuperscript{121} Id. § 1102(a)(2).
\item \textsuperscript{122} See id. § 1103(a).
\item \textsuperscript{123} See id. § 1103(c).
\end{itemize}
Chapter 11 cases. In most of these cases, committees are not organized,\textsuperscript{124} unencumbered assets of the estate may be insufficient to pay professional fees and committee expenses, and the size of even the largest unsecured claims may not justify the trouble and expense of serving on the committee.\textsuperscript{125} Further, committee members may not have sufficient expertise to serve effectively.\textsuperscript{126}

The rights of creditors to withdraw credit from the debtor present another constraint on DIP decision making.\textsuperscript{127} The automatic stay precludes creditors from collecting their claims after the bankruptcy filing,\textsuperscript{128} but secured creditors are entitled to relief from the stay under certain circumstances.\textsuperscript{129} Moreover, both secured and unsecured creditors may find leverage in withholding future credit to the business.\textsuperscript{130} Indeed, in many small and medium-sized businesses, the financing for continued operations will come from cash and receivables generated by the business that constitute cash collateral, which may be used only with the consent of the secured creditor or approval of the court upon a finding of adequate protection.\textsuperscript{131} The DIP typically must negotiate cash collateral and postpetition financing orders with the prepetition secured creditor, and the lender is likely to obtain significant restrictions on operations. Again, these sources of creditor control are limited in their effectiveness. If the debtor can provide adequate protection to secured creditors and find replacement vendors for those who withdraw future credit, the debtor is not otherwise constrained by these creditors' rights.\textsuperscript{132}

Finally, the discretion of managers to control the business in Chapter 11 is subject at all times to oversight by the bankruptcy court\textsuperscript{133} and monitoring by the United States Trustee, who may move to dismiss or convert a case as appropriate.\textsuperscript{134} As noted, the DIP must obtain court

\begin{itemize}
\item \textsuperscript{124} See LoPucki, \textit{supra} note 118, at 250-51 (finding that creditors committees were appointed in only 40\% of cases studied, that only 47\% of these committees hired counsel, and that only 11\% of these retained accountants); see also Jerome Kerkman, \textit{The Debtor in Full Control: A Case for the Adoption of the Trustee System}, 70 MARQ. L. REV. 159, 183 (1987) (finding that creditors’ committees were active in only 16-38\% of cases studied).
\item \textsuperscript{125} See LoPucki, \textit{supra} note 118, at 251.
\item \textsuperscript{126} See id. at 251-53; see also Adams, \textit{supra} note 5, at 615.
\item \textsuperscript{127} See LoPucki & Whitford, \textit{supra} note 5, at 701-04.
\item \textsuperscript{128} See 11 U.S.C. § 362(a).
\item \textsuperscript{129} See id. § 362(d).
\item \textsuperscript{130} See LoPucki & Whitford, \textit{supra} note 5, at 701-04.
\item \textsuperscript{131} See 11 U.S.C. § 363(b), (c).
\item \textsuperscript{132} The limited control creditors may exercise by withdrawing credit in bankruptcy contrasts sharply with the significant control creditors may exercise by withdrawing credit and seizing assets outside of bankruptcy. \textit{See supra} notes 67-68 and accompanying text.
\item \textsuperscript{133} See 11 U.S.C. § 105(a); see also LoPucki & Whitford, \textit{supra} note 5, at 716-19.
\item \textsuperscript{134} See 28 U.S.C. § 586(a)(3).
\end{itemize}
approval for activities outside the ordinary scope of business.\textsuperscript{135} Moreover, the Code authorizes the bankruptcy judge to actively manage his or her cases,\textsuperscript{136} and, as evidenced by the results of a study of judicial case management in the Central District of California, such techniques may significantly reduce the time debtors spend in Chapter 11.\textsuperscript{137} The effectiveness of judicial and governmental constraints on DIP authority depend on the particular judge or trustee, and crowded dockets undoubtedly limit the extent of their involvement.

\section*{C. Indirect Limits on Agency Costs in Chapter 11}

In addition to the direct constraints on DIP authority discussed in the preceding section, the Bankruptcy Code contains a number of provisions that may indirectly limit agency costs in Chapter 11. When the most efficient deployment decision is liquidation, a prompt liquidation may be brought about by the filing of a motion to dismiss or convert the case. Code section 1112 authorizes any party in interest, including the United States Trustee, to seek dismissal or conversion when there is no reasonable prospect of reorganization.\textsuperscript{138} Similarly, a secured creditor's motion for relief from the stay, if granted, may bring the case to a quick end when the motion concerns a major asset of the business. Under Code section 362(d), a secured creditor is entitled to relief from the stay if the debtor is unable to provide adequate protection of the creditor's collateral.\textsuperscript{139} If continuation of the business requires the use of cash collateral or postpetition financing, the denial of the motion for such use will also bring the case to a close and cause redeployment of the firm's assets. Under section 363, the DIP must adequately protect the secured creditor's interest in cash collateral,\textsuperscript{140} and under section 364, the court must determine that postpetition credit is in the best interest of the estate.\textsuperscript{141} Courts may also use the power to approve professional fees as a means to encourage efficient resolution of the case.\textsuperscript{142}

\footnotesize
\begin{itemize}
\item\textsuperscript{135} See supra notes 108-12 and accompanying text.
\item\textsuperscript{136} See 11 U.S.C. § 105(a).
\item\textsuperscript{138} See 11 U.S.C. § 1112(a).
\item\textsuperscript{139} See id. § 362(d)(1) (permitting relief from the stay for cause, including lack of adequate protection); see also id. § 362(d)(2) (permitting relief from the stay when the debtor lacks equity in the collateral and the collateral is not necessary to an effective reorganization); id. § 362(d)(3) (permitting relief from the stay when the debtor does not make interest payments to the secured creditor in a "single asset" case).
\item\textsuperscript{140} See id. § 363(c)(2).
\item\textsuperscript{141} See id. § 364(b)-(d).
\item\textsuperscript{142} See id. §§ 327-331.
\end{itemize}
D. Empirical Evidence of Failure in Chapter 11

In sum, the DIP system substitutes requirements for notice to creditors and approval by the court for many of the control (ratification and monitoring) functions exercised by residual owners outside of bankruptcy. In doing so, the Code fails to impose effective, equivalent restraints on the agency costs of debt and of the separation of residual ownership and control in Chapter 11.143 This failure is reflected in the low success rate of Chapter 11 filings. A plan is confirmed in only 26% of all Chapter 11 cases, and perhaps 25% of these plans are liquidation, not reorganization, plans.144 Moreover, between 30 and 40% of these plans are not fully performed.145

IV. Voting Under the Current Chapter 11 Regime

This Part summarizes the requirements for confirming a Chapter 11 plan and examines in detail the franchise features of this regime. This examination demonstrates that the principal purpose and effect of voting by claim and equity interest holders in Chapter 11 is to allocate the value of a firm among the various classes of claims and interests. The plan

143. See Skeel, supra note 6, at 482-84.

144. See Gordon Bermant & Edward Flynn, Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions, AM. BANKR. INST. J., Feb. 1998, at 8 (estimating that plans were confirmed in approximately 25.84% of Chapter 11 cases filed between January 1, 1989 and December 31, 1995); cf. Edward Flynn, Statistical Analysis of Chapter 11, Administrative Office of the U.S. Courts, at 10-13 (1989) (unpublished manuscript) (estimating that 17% of Chapter 11 filings from 1979 through 1986 resulted in a confirmed plan, and that more than 25% of these plans were liquidating plans; thus, only 10-12% of businesses seeking relief under Chapter 11 successfully reorganized); Susan Jensen-Conklin, Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law, 97 COM. L.J. 297, 318-19 (1992) (finding that approximately 17% of the 260 Chapter 11 cases filed between 1980 and 1989 in the Poughkeepsie Division of the U.S. Bankruptcy Court for the Southern District of New York reached confirmation of a plan, and that about 26% of the plans were liquidating plans).

145. See Jensen-Conklin, supra note 144, at 323-25 (finding 42% of confirmed reorganization (not liquidation) plans were not fully consummated; thus, the percentage of Chapter 11 debtors who successfully confirmed and consummated a plan of reorganization in the cases studied was 6.5%); see also LoPucki & Whitford, supra note 144, at 608 (finding that 32% of large, publicly held corporations filed a second Chapter 11 petition within several years after confirming a plan of reorganization).
confirmation scheme in Chapter 11 does not provide claim or interest holders a decisive role in deployment issues. Rather, the court holds final authority over whether a proposed reorganization is the most efficient response to the debtor’s financial crisis. Congress arguably intended one of the voting requirements, section 1129(a)(10), to require residual owner approval for a proposed reorganization. The courts have misunderstood and misapplied this section, however, and it has not been an effective constraint on agency costs. The next Part of this Article recommends amending section 1129(a)(10) to require residual owner endorsement of a plan as a condition to confirmation.

A. Overview of the Chapter 11 Confirmation Scheme

The major premise of Chapter 11 is that a firm may be more valuable to claim and interest holders as a going concern than if it is liquidated. Thus, a plan of reorganization may not be confirmed unless each claim will be paid at least as much as it would in liquidation and the plan is feasible. The best interests and feasibility requirements together address the question of whether reorganization or liquidation is the more efficient response to the debtor’s financial distress. The best interests test ensures baseline protection concerning payment of creditor claims, while the feasibility requirement assures that the proposed reorganization is

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146. There is an important debate over the normative justifications of Chapter 11. Under the “creditors’ bargain” theory, the sole legitimate purpose of reorganization is to preserve the higher, going concern value of a firm for the benefit of creditors. See, e.g., Baird & Jackson, supra note 11, at 100-01; Jackson, supra note 74, at 209-24. In other words, the reorganization law is justified on the ground that it represents the agreement creditors would reach among themselves. Other commentators posit that Chapter 11 serves broader purposes, such as the preservation of employment or community. They do not dispute, however, that a principal justification for the business reorganization provisions is preservation of the going concern surplus. See, e.g., Elizabeth Warren, Bankruptcy Policymaking in an Imperfect World, 92 MICH. L. REV. 336, 350-52 (1993). See also H.R. REP. NO. 95-595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, at 6179, which states:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

This Article takes no position in this debate. Regardless of the normative justification for Chapter 11, the system can be improved by limiting agency costs of DIP management. See Richard V. Butler & Scott M. Gippatric, A Re-Examination of the Purposes and Goals of Bankruptcy, 2 AM. BANKR. INST. L. REV. 269, 282-84 (1994) (explaining that even if the going concern surplus is defined to include societal benefits of continued operation of the business, the latter cannot be preserved unless income exceeds costs of production).


148. See id. § 1129(a)(11).
likely to succeed. Notably, the Code commits both of these determinations to the court.\textsuperscript{149}

In addition to the best interests and feasibility requirements, a Chapter 11 plan must be accepted by all classes,\textsuperscript{150} or else comply with the absolute priority rule with respect to any dissenting class.\textsuperscript{151} The absolute priority rule states that no junior class of claims or interests may receive any payment unless all senior classes are paid in full.\textsuperscript{152} Further, and in any event, the plan must be accepted by at least one class of impaired claims, excluding the votes of insiders, if any class of claims is impaired by the plan.\textsuperscript{153}

\section*{B. Sections 1129(a)(8) and (b) and Allocation of the Going Concern Surplus}

The vote of the various classes of claims and equity interests determines the allocation of the going concern surplus (the difference between the going concern and liquidation values) among the classes. When a class votes to accept a plan under section 1129(a)(8), it waives its right to the protection of the absolute priority rule under section 1129(b).\textsuperscript{154} Conversely, a plan must comply with the absolute priority rule with respect to any dissenting class, that is, the plan must treat the claims in a dissenting class in accordance with the state law entitlements represented by their claims.\textsuperscript{155} Thus, while the best interests test ensures a minimum level of protection to individual creditors respecting payment of their claims,\textsuperscript{156} the "cramdown" protections mandate that classes of claims will be treated in accordance with their nonbankruptcy

\begin{itemize}
  \item \textsuperscript{149} See id. § 1129(a)(7), (11).
  \item \textsuperscript{150} See id. § 1129(a)(8). A plan must designate classes of claims and interests. See id. § 1123(a)(1). A plan may place a claim or an interest in a class only if it is substantially similar to the other claims or interests in the class. See id. § 1122. The plan must specify the treatment of each class. See id. § 1123(a)(2), (3). See generally Scott F. Norberg, Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification, 69 AM. BANKR. L.J. 119, 147-49 (1995) (discussing the Chapter 11 classification rules).
  \item \textsuperscript{151} See 11 U.S.C. § 1129(b)(2)(B), (C). Unimpaired classes of claim and equity holders are deemed to have accepted the plan, see id. § 1126(f), while classes that will receive nothing under the plan are deemed to reject the plan, see id. § 1126(g). The deemed rejection by classes that will receive nothing under the plan simply means these classes are automatically protected by the absolute priority rule. Thus, only impaired claims or interests that will receive a distribution are entitled to vote on the plan. A class is unimpaired if the plan leaves unaltered the rights of the claim or interest holders, or the proponent proposes to cure and reinstate the obligation according to its original maturity. See id. § 1124.
  \item \textsuperscript{152} See id. § 1129(b)(2)(B), (C).
  \item \textsuperscript{153} See id. § 1129(a)(10).
  \item \textsuperscript{154} See id. § 1129(a)(8), (b).
  \item \textsuperscript{155} See id.
  \item \textsuperscript{156} See id. § 1129(a)(7).
\end{itemize}
entitlements unless otherwise agreed. The vote of each class determines whether that class waives or retains its rights under the absolute priority rule, and thereby determines how the going concern surplus will be divided among the various classes. 157

The Code requires a supermajority vote of the claimants comprising a given class for acceptance of the plan and waiver of the cramdown protections, and the vote of a class binds each member of the class; acceptance by the required majority of claimants in a class overrides the state law rights of any dissenters in the class. 158 Section 1126(c) states that a class of claims accepts a plan if at least two-thirds in amount and more than one-half in number of the holders of claims in the class accept the plan. 159 Stated differently, creditors holding slightly more than two-thirds of the debt in the class, or one-half in number of the claims in the class, may block acceptance by the class. 160 The votes of all claim holders, insiders 161 and noninsiders alike, are counted for purposes of section 1129(a)(8), 162 except that votes cast in bad faith may be disqualified. 163

The supermajority voting requirement is not explained by the legislative history to the Bankruptcy Code. It was derived from the voting requirements of Chapters X and XI of the former Bankruptcy Act, although the nature of the creditor franchise under the former Act was very different than under the present Chapter 11. 164 The supermajority

157. See id. § 1129(a)(8), (b). The negotiation may, for example, pit unsecured creditors, who are the residual owners of the firm, against the equity interest holders, whose claims are worth nothing in liquidation. The unsecured creditors may agree to yield some of their rights under the absolute priority rule to the equity interest holders in order to entice the shareholder-managers to continue to manage the firm, which will enable the unsecured creditors to receive more than they would receive in liquidation. See generally Todd J. Zywicki, Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code, 19 T. MARSHALL L. REV. 241 (1994).

158. See 11 U.S.C. §§ 1126(c)-(d), 1129(a)(8), (b).

159. See id. § 1126(c).

160. See id. The requirements for acceptance by a class of equity interests do not include a numerosity requirement. A class of interests accepts a plan if holders of more than two-thirds in amount of the interests in the class vote to accept the plan. See id. § 1126(d).

161. "Insider" is defined in section 101(31). If the debtor is a corporation, the term includes officers, directors, and any other person in control of the debtor. See id. § 101(31)(B).

162. See id. § 1129(a)(8).

163. See id. § 1126(e).

164. Under Chapter X of the Bankruptcy Act, confirmation required acceptance by two-thirds in amount of the claims in each class, without any provision as to the number of claims that had to accept, but the vote was unrelated to waiver of the absolute priority rule or allocation of the going concern surplus. See Chandler Act, ch. 575, § 179, 52 Stat. 840, 892 (1938) (repealed 1978). Chapter X extended the absolute priority rule to each individual creditor so that a plan could not be confirmed unless it complied with the rule or all creditors accepted the plan. At the same time, a plan could be confirmed under Chapter X over the dissent of any or all classes as long as the interests of the dissenting classes were adequately protected by the plan. See id. § 221(2), 52 Stat.
standard may be justified on several related grounds. First, it ensures that a vote to accept the plan (that is, to waive the cramdown protections) will "reflect the feelings of a sufficient number of claims of a class of a sufficient monetary amount to make it fair and equitable for all the members of the class."

In other words, the Code does not lightly bind dissenters to a decision to waive the priority entitlements of the class. Further, the rule decreases the instances in which the votes of insiders or others with additional stakes in the firm will be able to override the desires of disinterested claim holders. Because the section 1129(a)(8) vote includes all claim holders (except those disqualified on bad faith grounds), there is the potential that insider claims will dominate one or more classes and that the insiders will vote to protect their interests as shareholders and managers instead of their interests as creditors. The requirement may also be seen as a response to the collective choice problem; like shareholders in publicly held companies, creditors are often widely dispersed and therefore are not informed or do not vote on the plan.

Skeel argues that despite superficial differences between the state and bankruptcy law voting regimes, there are significant parallels. The most striking dissimilarity is that the franchise in a solvent corporation outside of bankruptcy is held exclusively by the residual owners (shareholders), while in bankruptcy most classes of creditors and equity holders have the right to vote. Skeel argues that the right to vote in Chapter 11 must be given to each class because the voting will affect the rights of each class, and permitting one class to decide the rights of other classes would pose a clear threat of opportunistic behavior by the voting class. He also contends that the Code tends to focus voting power in the residual classes by providing that unimpaired classes are deemed to

at 897; id. § 216(7)-(8), 52 Stat. at 895-96.

Under Chapter XI, confirmation required acceptance by more than one-half in amount and one-half in number of the claims in each class. See id. § 362(1), 52 Stat. at 911. Again, the vote had nothing to do with the absolute priority rule or allocation of the going concern surplus; the absolute priority rule did not apply in Chapter XI. See id. § 366, 52 Stat. at 911-12 (as amended 1952). A Chapter XI plan could not be confirmed unless accepted by all classes. See id. § 362(1), 52 Stat. at 911; id. § 366, 52 Stat. at 911-12.


166. See Skeel, supra note 6, at 489.

167. See id. at 479-81.

168. See id. at 479-80. Skeel notes that under state law, changes in the rights of a particular class of shareholders must be approved by the class. See id. at 491-92. Unlike the bankruptcy regime, however, the state rule requires approval of such changes by all shareholders in addition to the affected class. See REV. MODEL BUS. CORP. ACT §§ 10.03, 10.04 (1991).
accept the plan and that classes receiving nothing are deemed to reject the plan.169

While the fact that only impaired creditors may vote on a plan tends to focus voting rights on the residual ownership class, section 1129(a)(8) is designed neither to require approval by the residual class nor to address the deployment decision. Indeed, approval by the residual owner class would be largely coincidental under section 1129(a)(8), because section 1129(b) permits cramdown against any dissenting class. Consider, for example, a debtor with assets worth $100, a single secured creditor holding a claim of $75 secured by a security interest in all of the assets, and unsecured creditors holding claims totaling $50. Suppose the debtor proposes a plan that impairs both the oversecured creditor and the unsecured class, and that the oversecured creditor accepts the plan while the unsecured class votes to reject. The unsecured creditors probably should be considered the residual claimants, yet the plan can be confirmed over their rejection if it complies with the absolute priority rule. Further, although a class might reject a plan for the reason that it does not make the right deployment decision, the only way to raise this issue directly is by filing an objection to the plan on the ground that creditors would receive more in liquidation or that the plan is not feasible, which would be decided by the court. That section 1129(a)(8) is not concerned with the deployment decision is further evidenced by the fact that all claimants, including insiders, are entitled to vote.170 In other words, section 1129(a)(8) is not concerned with agency costs arising from the fact that some claimants may have equity or other interests in the firm that might induce them to favor reorganization even when that will not maximize the welfare of the firm. Indeed, the inclusion of multiple groups in the Chapter 11 vote is a source of agency costs.171 The section 1129(a)(8) franchise in Chapter 11 exacerbates instead of limits agency costs.

The section 1129(a)(8) voting requirement is analogous to state corporate voting rules that require approval of proposed changes by each class of shares whose rights are proposed to be changed.172 But unlike the Chapter 11 voting regime, these state law provisions also require approval of any such changes by the common shareholders, who are normally the residual class.173 Section 1129(a)(8) requires only that each

169. See Skeel, supra note 6, at 479-80. See supra note 151 and infra note 190 for explanation of "impairment."
171. See Easterbrook & Fischel, supra note 14, at 405.
172. See REV. MODEL BUS. CORP. ACT §§ 10.03, 10.04, see also Skeel, supra note 6, at 491-92.
173. See Skeel, supra note 6, at 491-92.
class approve alteration of the class members’ state law rights to payment according to their contracts and does not mandate residual owner approval of the plan.\textsuperscript{174}

C. \textit{Section 1129(a)(10) and the Decision to Reorganize}

Section 1129(a)(10) is among the most enigmatic and frequently litigated provisions of the Code.\textsuperscript{175} It requires as a condition to confirmation of a plan that “[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.”\textsuperscript{176} This provision is best understood as requiring acceptance by a class of residual claimants with appropriate incentives to decide whether a proposed plan makes an efficient deployment decision. However, the courts have misunderstood and frequently misapplied the requirement by permitting strategic uses of the classification\textsuperscript{177} and impairment\textsuperscript{178} rules by plan proponents.

1. The Purpose of Section 1129(a)(10)

Congress added section 1129(a)(10) to the 1978 Bankruptcy Code late in the legislative process,\textsuperscript{179} apparently at the behest of banks and insurance companies.\textsuperscript{180} As originally enacted, it provided that “[t]he court shall confirm a plan only if . . . at least one class of claims has accepted the plan, determined without including any acceptance of the plan by any insider holding a claim of such class.”\textsuperscript{181} The legislative reports accompanying the 1978 Code shed no light on the purpose of the provision.\textsuperscript{182}

Congress amended section 1129(a)(10) in 1984 to clarify that it requires acceptance by an \textit{impaired} class, and that a deemed accepting

\textsuperscript{174} See \textit{11} U.S.C. § 1129(a)(8), (b).

\textsuperscript{175} See cases cited \textit{infra} notes 185, 197, 203, and 205-06; \textit{see also} \textit{REFORMING THE BANKRUPTCY CODE}, \textit{supra} note 10, at 276-77; Norberg, \textit{supra} note 150, at 147-49.

\textsuperscript{176} \textit{11} U.S.C. § 1129(a)(10).

\textsuperscript{177} \textit{See id. § 1122.}

\textsuperscript{178} \textit{See id. § 1124.}


class does not satisfy the provision. This change was not accompanied by any report. A Senate Report to similar legislation introduced but not enacted in 1979 stated cryptically that the revision was meant to ensure acceptance of a plan by a "real class" of creditors.

The legislative history, then, sheds little light on the rationale for section 1129(a)(10). Three observations of the statute itself suggest that it mandates residual owner support of a plan. First, although courts generally have regarded section 1129(a)(10) as a condition to cramdown, it is in fact a requirement for confirmation regardless of whether a plan is accepted by all classes pursuant to section 1129(a)(8). In other words, even if every class of impaired claims accepts a plan, the plan may not be confirmed unless at least one impaired class accepts the plan while excluding the votes of any insiders. Section 1129(a)(10) imposes a requirement that is separate from and additional to section 1129(a)(8). Whereas the class vote under section 1129(a)(8) includes both insiders and noninsiders, the section 1129(a)(10) vote excludes

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183. Recall section 1126(f) provides that an unimpaired class is automatically and conclusively deemed to accept the plan. See supra note 151.
184. This amendment makes clear the intent of section 1129(a)(10) that one 'real' class of creditors must vote for the plan of reorganization. A class that is deemed to have accepted the plan because it is unimpaired or acceptance of a small class of claims permitted to be created for administrative convenience will not satisfy this requirement.

Under chapter XII of the former act, debtors were able to cram down on non-accepting creditors a plan which no creditor whose claim had been impaired had agreed to. . . .

. . . Creditors whose claims were impaired by the debtor's proposal to pay less than 100 percent should not be forced to accept a plan unless some other creditor whose claim was impaired had agreed to the plan.

Therefore, Mr. Speaker, under 1129(a)(10) as it is proposed to be amended, a creditor whose claim is impaired under section 1124 must first accept the debtor's plan before the plan can be crammed down with respect to other impaired nonaccepting creditors.

185. See, e.g., Windsor on the River Assocs., Ltd. v. Balcor Real Estate Fin., Inc. (In re Windsor on the River Assocs., Ltd.), 7 F.3d 127, 131 (8th Cir. 1993); In re Duval Manor Assocs., 203 B.R. 42, 44 n.1 (Bankr. E.D. Pa. 1996); In re Fur Creations by Varriale, Ltd., 188 B.R. 754, 760 (Bankr. S.D.N.Y. 1995) (citing In re 500 Fifth Ave. Assoc., 148 B.R. 1010, 1020 (Bankr. S.D.N.Y. 1993)) (stating that section 1129(a)(10) "ensures that prior to 'embarking on the tortuous path of cramdown and compelling the target of cramdown to shoulder the risks of error necessarily associated with a forced confirmation,' there is a showing that some group hurt by the plan favors the plan"); In re 266 Washington Assocs., 141 B.R. 275, 287 (Bankr. E.D.N.Y. 1992) (stating that section 1129(a)(10) acts as a "statutory gatekeeper barring access to cram down where there is absent even one impaired class accepting the plan").
186. See 11 U.S.C. § 1129(a) (1994) ("The court shall confirm a plan only if all of the following requirements are met . . . .").
187. See id. § 1129(a)(10).
VOTING THEORY IN CHAPTER 11

insiders. A plan might be accepted by all classes when counting the votes of insiders, but not by any impaired class excluding the ballots cast by insiders.

Second, the exclusion of insider votes under section 1129(a)(10) ensures that the required vote is not tainted by claimants' conflicting equity or employment interests in the firm. The shareholder-managers of the firm often are also significant creditors of the firm. Section 1129(a)(10) anticipates that they may cast their votes in furtherance of their interests as shareholders and managers (which as discussed at length above, differ greatly from the interests of residual owners) and therefore excludes them from the vote. Stated differently, section 1129(a)(10) limits agency costs by restricting the vote thereunder to claim holders as claim holders.

Third, section 1129(a)(10) requires acceptance by an impaired class. While an impaired class will not necessarily be comprised of residual owners, the residual ownership class will by definition be an impaired class. Under section 1124, a class is impaired unless the plan leaves unaltered the rights of the claim holders or cures and reinstates the claims in the class. The residual owners of a firm are the class of claim or equity holders that will receive the remaining value of the firm after all senior claims and interests are paid in full and thus hold both the potential for gain and the risk of loss resulting from deployment decisions.

In sum, section 1129(a)(10) should be seen as an attempt to ensure that a proposed plan is approved by at least one class of claims with a

188. See id.

189. See In re United Marine, Inc., 197 B.R. 942, 946 (Bankr. S.D. Fla. 1996) (holding that insider votes are counted for purposes of section 1129(a)(8)); In re Gilbert, 104 B.R. 206 (Bankr. W.D. Mo. 1989) (same); In re Grimes Furniture, Inc., 47 B.R. 68 (Bankr. W.D. Pa. 1985) (same). To illustrate, consider a plan that has been accepted by all classes of claims including the general unsecured class, which is impaired by the plan. Assume that the general unsecured class is composed of $100,000 in claims, $30,000 of which are held by the debtor's president and major shareholder. Further assume that 70% of the general unsecured class accepted the plan, including the shareholder-president. Excluding his vote, only 4/7 or 57% of the class accepted the plan. Thus, the plan complies with section 1129(a)(8) but not (a)(10), unless there is another impaired class that has voted to accept the plan without counting the votes of any insider in the class.

190. See 11 U.S.C. § 1124. A class impaired under section 1124 may be one which (1) the plan pays less than required by the cramdown rules (in which case the plan may not be confirmed unless the class accepts the plan), or (2) the plan pays in accordance with the cramdown rules but not in full (in which case the plan may be confirmed without acceptance by the class). In the former case, by accepting the plan the class agrees to yield some of its rights under the absolute priority rule because it anticipates a better result from the reorganization than from liquidation. In the latter, the class must take a loss but is assured that it will receive more than in liquidation and that junior claims will not share in the going concern surplus at the expense of the dissenting class. See id. § 1129(b).

191. See supra notes 21-23 and accompanying text.
residual ownership interest in the debtor that does not hold a conflicting stake in the case. Whereas in liquidation a firm's assets are sold to third parties, in Chapter 11 the assets are in effect sold to the creditors. A "critical question" in Chapter 11 is whether reorganization will yield more for creditors than liquidation. When no group of residual owners with the proper incentives to maximize the firm's welfare approves a plan, it follows that they do not see a greater benefit in reorganization than in liquidation.

Under this view, section 1129(a)(10) is partially redundant of sections 1129(a)(7) and (a)(11), which condition confirmation on findings that each creditor will receive more under the plan than in liquidation and that the plan is feasible, regardless of acceptance by the various classes. However, the judgment of noninsider impaired creditors on these questions would be an important check on the courts' power and a reinforcement for the courts' competence to judge the viability of a business.

2. Strategic Classification and Strategic Impairment of Claims

The courts are divided over the import of section 1129(a)(10). The usual battleground for whether a plan complies with the provision is a single asset real estate case in which the debtor's principal asset is a shopping mall, apartment complex, or office building. The creditors of the debtor generally include: (1) a financial institution that made a loan secured by the debtor's assets, now worth less than the amount of the lender's claim, and (2) unsecured trade creditors. Pursuant to Code section 506(a), the undersecured lender holds a secured claim in an amount equal to the value of the property, and an unsecured claim for the balance of the debt. Because the lender has an unsecured claim for the deficiency, it is entitled to vote on the plan as an unsecured creditor. Because the lender ordinarily holds more than two-thirds of the total unsecured debt, it is usually in a position to cause a class comprising all unsecured claims to vote to reject the plan. Assuming that the lender will vote both its secured and unsecured claims against the plan, the plan will be unconfirmable for lack of acceptance by an impaired, accepting class as required by section 1129(a)(10).

In order to meet the impaired, accepting class requirement and confirm a plan over the undersecured lender's opposition, debtors have submitted

192. See Jackson, supra note 74, at 210-11.
193. See id. at 209-10; see also supra note 146 and accompanying text.
195. See id. § 506(a).
196. See Norberg, supra note 150, at 153-60.
plans that classify the lender’s unsecured deficiency claim separately from the unsecured trade claims, proposing to impair the trade class but treat it sufficiently favorably to procure its vote in favor of the plan. Many courts have approved this “artificial classification” strategy, reasoning in part that section 1129(a)(10) simply ensures that a plan cannot be crammed down over the opposition of all creditors. In their view, section 1129(a)(10) requires only some minimal level of support from creditors impaired by the plan.Obviously, if their analysis governed, compliance with section 1129(a)(10) would not indicate residual owner support for the plan. Rather, in such cases the court alone determines whether the plan is feasible and in the best interests of creditors.

A majority of courts have disapproved separate classification of similar claims in the absence of a legitimate business justification for treating the separate classes of similar claims differently. In those courts, the result is almost always that the residual owner—the undersecured lender—decides the reorganization versus liquidation question. When all similar claims are classified together (and the impairment of the claims in the impaired, accepting class is necessary, not artificial), the undersecured creditor determines whether a reorganization will go forward. There is no going concern surplus in single asset real estate cases, and the risk of loss is borne mainly by the residual claimant. A vote by the undersecured lender/residual owner under section 1129(a)(10) that determines approval of the plan is justified by agency cost analysis—the class with the appropriate incentives to make an efficient decision has responsibility for deciding the fate of the firm. Further, even if going concern value exceeded liquidation value, the undersecured lender has the appropriate incentives to determine whether the proposed deployment of assets is efficient.

Even when a plan classifies similar claims (e.g., an undersecured lender’s unsecured deficiency claim and unsecured trade claims) together, section 1129(a)(10) will not ascertain residual owner support for the plan if the claims in a proper class are “artificially” impaired. “Artificial” impairment occurs when the plan alters the rights of the claim holders not


198. See Norberg, supra note 150, at 153-60 (discussing cases disapproving separate classification of similar claims); see also In re Fur Creations by Varriale, Ltd., 188 B.R. 754, 760-61 (Bankr. S.D.N.Y. 1995).

199. See infra notes 201-05 and accompanying text (discussing “artificial impairment”).

because the impairment is necessary to restructure the business operations but in order to satisfy the impaired, accepting class requirement. In other words, section 1129(a)(10) admits the possibility that the accepting impaired class is not the residual class. For example, a plan must separately classify unsecured employees' wage claims (because they have priority over most other unsecured claims\(^{201}\)) and each secured claim against the debtor.\(^{202}\) When such claims are relatively minor, there may be little business purpose to impairing them. However, the plan proponent might nevertheless slightly impair the claims so as to engineer an impaired accepting class.\(^{203}\) As in the case of artificial classification, acceptance by an "artificially" impaired class does not signal residual owner support for the proposed deployment of assets under the plan.\(^{204}\) Again, the courts addressing the issue are divided on whether the Code permits unnecessary impairment of claims for purposes of meeting the section 1129(a)(10) requirement.\(^{205}\)


\(^{203}\) Cf In re United Marine, Inc., 197 B.R. 942, 945 (Bankr. S.D. Fla. 1996) (holding that acceptance by $125,000 secured claim satisfied section 1129(a)(10) in case involving over $7 million in total debt).

\(^{204}\) As another example, assume impairment of an oversecured creditor's claim that is necessary, not "artificial." The impaired, oversecured creditor class probably would not be considered the residual ownership class, but acceptance by this class will satisfy section 1129(a)(10). (Arguably, though, the oversecured creditor whose claim is neither cured and reinstated nor paid in full on the effective date of the plan should be considered a residual claimant because it risks nonpayment of its claim should the plan fail. While a vote against the plan by the oversecured creditor should not be determinative of the reorganization versus liquidation issue, its vote in favor of the plan does indicate that the plan has the support of a party with something on the line. This analysis ultimately is unsatisfactory because the oversecured creditor does not stand to gain from any upside potential of the deployment decision and, depending on the extent to which it is oversecured, may bear very little of the downside risk.)

\(^{205}\) The only two circuit courts that have directly addressed the issue are split. See Windsor on the River Assocs., Ltd. v. Balcor Real Estate Fin., Inc. (In re Windsor on the River Assocs., Ltd.), 7 F.3d 127 (8th Cir. 1993) (disapproving artificial impairment because it renders section 1129(a)(10) a dead letter and produces an absurd result); L & J Anaheim Assocs. v. Kawasaki Leasing Int'l, Inc. (In re L. & J Anaheim Assocs.), 995 F.2d 940 (9th Cir. 1993) (approving creditor plan proponent's artificial impairment of its own claim by strictly construing section 1124's definition of impairment as any alteration in creditor rights); see also David Gray Carlson, The Classification Veto in Single-Asset Cases Under Bankruptcy Code Section 1129(a)(10), 44 S.C.L. Rev. 565, 610-14 (1993); cf. Bank of America, Illinois v. 203 North Lasalle St. Partnership, 195 B.R. 692 (Bankr. N.D. Ill. 1996) (approving slight impairment of relatively small class when the impairment, although not absolutely necessary, was not solely to obtain impaired accepting class).

Congress amended section 1124 in 1994 to provide that a class of claims is impaired even when the plan proposes to pay them in full. See Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 213(d), 108 Stat. 4126 (repealing 11 U.S.C. § 1124(3) (1988)). The amendment arguably sanctions artificial impairment by stating that claims are impaired notwithstanding payment in full,
In a few cases, involving solvent debtors, the plan is accepted by an artificially impaired class of claims but has the support of the residual owners. For example, when a solvent debtor's plan impairs the primary secured lender's claim and unnecessarily impairs a class of unsecured trade claims, a rule against artificial impairment of a class meeting the section 1129(a)(10) requirement might preclude confirmation of a plan supported by the residual owners, here the class of equity interests. Arguably, though, the solvent debtor is even less deserving of protection under Chapter 11 than the debtor who has filed to protect creditor interests.

V. LIMITING THE AGENCY COSTS OF DIP CONTROL IN CHAPTER 11 THROUGH USE OF A RESIDUAL OWNER FRANCHISE

The central dilemma under the current Chapter 11 regime is that in most cases the managers who control the debtor are not the residual owners and do not possess appropriate incentives to make efficient asset deployment decisions. This Part considers whether the agency costs of the separation of residual ownership and control in Chapter 11 may be more effectively constrained by incorporating into Chapter 11 a residual owner franchise analogous to the shareholder franchise in solvent firms outside of bankruptcy. This discussion is divided into two parts. The first considers residual owner suffrage during the pendency of the case. The second addresses whether residual owner approval should be required for confirmation of a plan.

A. Residual Owner Voting During the Pendency of a Case

One response to the agency cost problem in Chapter 11 would be for the Code to grant voting rights to the residual owners of the debtor upon

contradicting the premise that section 1129(a)(10) mandates residual owner consent. See Equitable Life Ins. Co. v. Atlanta-Stewart Partners (In re Atlanta-Stewart Partners), 193 B.R. 79 (Bankr. N.D. Ga. 1996) (holding that acceptance by class of claims to be paid in full without interest satisfied section 1129(a)(10) although the impairment was not necessary to restructure the debtor's debts); accord PNC Bank, Nat'l Ass'n v. Park Forest Dev. Corp. (In re Park Forest Dev. Corp.), 197 B.R. 388 (Bankr. N.D. Ga. 1996). On the other hand, the House Report states the amendment was intended to reverse the "unfair result" in In re New Valley Corp., 168 B.R. 73 (Bankr. D. N.J. 1994), in which the court held that a class was not impaired when the solvent debtor's plan provided for payment in full without postpetition interest. H.R. REP. NO. 103-835, at 47-48 (1994).

206. See, e.g., In re Windsor on the River Assocs., Ltd., 7 F.3d at 132 (disapproving impairment when "the alteration of rights ... arises solely from the debtor's exercise of discretion"); 203 North Lasalle St. Partnership, 195 B.R. at 692 (approving slight impairment of relatively small class when the impairment, although not absolutely necessary, was not solely to obtain impaired accepting class); In re Curtis Center Ltd. Partnership, 192 B.R. 648, 658-59 (Bankr. E.D. Pa. 1996); In re Dunes Hotel Assocs., 188 B.R. 174 (Bankr. D. S.C. 1995).

207. See Carlson, supra note 200, at 357-59.
the filing of a petition, giving these claimants authority from the outset of the case to remove managers and approve significant deployment decisions. As in solvent companies outside of bankruptcy, a residual owner franchise in Chapter 11 would check managers' inappropriate incentives and limit agency costs arising from the separation of residual ownership and control of the debtor.

The costs of transferring voting rights to residual owners immediately upon bankruptcy would probably outweigh the benefits, however. Identifying the residual owners at the early stages of a Chapter 11 case would require valuation of all firm assets, and valuation is typically time-consuming, expensive and less than reliable.\textsuperscript{208} Further, unless and until extinguished, even the equity interests in an insolvent firm have some value; there is always a chance that the firm's fortunes will take a turn for the better and yield value to the equity interests.\textsuperscript{209}

Skeel has argued that in large cases the DIP should be more accountable to residual owners during the pendency of a Chapter 11 case, in particular respecting asset sales and directorial elections.\textsuperscript{210} Recognizing the difficulties in designating the residual class, he proposes that the Code set a rule for all cases granting the class of general unsecured creditors authority to approve asset sales and replace management.\textsuperscript{211} He argues that unsecured creditors are the residual owners in most large cases\textsuperscript{212} and


\textsuperscript{209} See LoPucki & Whitford, \textit{supra} note 5, at 771-76; Skeel, \textit{supra} note 6, at 487.

\textsuperscript{210} See Skeel, \textit{supra} note 6, at 498-501, 510-12.

\textsuperscript{211} See id.

\textsuperscript{212} In a few large debtor cases, though, the debtor is solvent and the equity holders therefore
that the costs that may arise from the clear rule when unsecured creditors are not the residual owners may be justified by the benefits of a clear rule.213

While a fixed rule granting decision-making authority to unsecured creditors might be appropriate in large cases, an undersecured primary creditor often is the residual claimant in small and medium-sized cases. In these cases a per se rule giving the franchise to unsecured creditors would mean that a class lacking appropriate incentives to maximize firm value frequently would hold decision-making authority.

Finally, even if the residual class could be identified without undue difficulty, a rule transferring voting authority to residual claimants upon the filing of a petition, like a rule requiring appointment of a trustee, would likely deter viable businesses from seeking Chapter 11 relief until it is too late.214 In the cases of small and medium-sized debtors, the already-strapped business usually could not survive the added costs of a change in management or the appointment of a trustee.215

B. Residual Owner Voting on Confirmation of a Plan

1. Requiring Residual Owner Approval

While a requirement for residual owner approval of the plan would not directly address the significant agency costs that may be incurred between the filing of a petition and the resolution of a case by dismissal, conversion, or confirmation of a plan,216 it would ensure that reorganiza-

213. See Skeel, supra note 6, at 500-05. One cost of the per se rule proposed by Skeel would be the necessity in some cases of valuing collateral of undersecured creditors in order to determine the amount of the creditors' claims to be counted in the balloting. Also, asset values can fluctuate during the pendency of the case, changing the amount of claims in the unsecured class.

214. See LoPucki & Whitford, supra note 5, at 756-58 (arguing that Chapter 11 relies mostly on voluntary filings, and that filings will be delayed by rules that immediately divest managers of control). Skeel's proposal is less problematic than a rule transferring authority to the residual class immediately upon filing in that it calls for voting by the residual class only on certain matters—asset sales and directorial elections—and not a complete transfer of authority. See Skeel, supra note 6, at 494-512. But see Cuevas, supra note 5, at 404-16 (proposing that at the inception of a Chapter 11 case unsecured creditors have the option of replacing existing management with a trustee).

215. See supra notes 107-08 and accompanying text (discussing the utility of the Code provision for appointment of a trustee as a limit on agency costs of DIP management).

216. The most effective response to the agency costs of DIP control that arise during the preconfirmation period may be to require debtors to file plans within a specified time so as to minimize the length of time spent in Chapter 11. It is not enough, at least in small and medium-sized cases where creditors are unlikely to propose a plan, to simply curtail extensions of exclusivity. Many commentators have urged more aggressive steps to limit the time debtors spend in Chapter 11. See, e.g., LoPucki, The Trouble with Chapter 11, supra note 5, at 749-56 (calling for "preemptive cramdown" that would extinguish the interests of shareholders in clearly insolvent debtors in large
tion plan decisions are approved by the owners who will reap the benefit and incur the detriment of the decisions. Such a mandate would directly respond to the problem of so many confirmed plans not being consummated.217 In addition to the feasibility218 and best interests219 determinations made by the court, a requirement for residual owner approval would mean that the claim or equity holders with the appropriate incentives to maximize the value of the firm will also decide these issues. The residual owners have better incentives than the bankruptcy judge, who has no financial stake in the firm, to make efficient deployment decisions. Agency costs analysis teaches that the quality of the feasibility and best interests decisions will improve when the decision maker has appropriate incentives to make an efficient decision. If the quality of these decisions is improved, fewer nonfeasible plans will be confirmed and more confirmed plans will be consummated.

Moreover, requiring residual owner approval of a plan would force the DIP to respond directly to the residual owners on asset deployment issues during the negotiation of a plan. In the same way that the DIP under the current Code must negotiate with classes of claimants concerning allocation of the value of the firm,220 a residual owner franchise would compel the DIP to negotiate with the residual owners on the asset deployment issues. Under the current Code, the plan proponent must show the court that a plan is feasible and will pay each creditor more than it would receive in liquidation,221 but these issues are not set squarely on the table for consideration or negotiation by the creditors. Individual creditors may object to confirmation on the grounds that the plan is not feasible or does not meet the best interests test, but the court, not the residual owner class, has the final word.222 Although a class might reject a plan under the current Code on the ground that it does not make the right deployment decision, the dissenting class may or may not

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217. See Jensen-Conklin, supra note 144, at 323-25 (finding that 42% of confirmed reorganization plans in cases filed between 1980 and 1989 in the Poughkeepsie Division of the Southern District of New York were not consummated).


219. See id. § 1129(a)(7).

220. See id. § 1129(a)(8), (b); see also discussion supra Part IV.B.


222. See id.
represent residual owners generally and may be crammed down by decision of the court.

2. Identifying the Residual Owner Class

A requirement for residual owner approval of a plan would, of course, require identification of the members of the residual owner class. Identifying this class at the time of confirmation would not entail the same problems as doing so prior to confirmation. Unless all creditors accept the plan (in which case there is no issue of residual owner approval), the court must value the assets of the business in order to determine whether the plan complies with the best interests test. That liquidation analysis will determine the residual ownership class by ascertaining what creditors would receive in liquidation. While identifying the residual ownership class before confirmation involves collapsing future values to a present value, which may ignore potential future increases in the value of the business, the confirmation of a plan finally determines each claimant’s rights in the reorganized firm.

In most cases, the residual ownership class will be a class that has already been designated for purposes of sections 1129(a)(8) and (b), which provide for a vote by each class on waiving or retaining protection of the absolute priority rule. In some cases, the residual ownership class will be comprised of the claimants in more than one of the section 1129(a)(8) classes. For example, when a plan designates more than one class of general unsecured creditors and the value of the debtor’s assets exceeds the sum of the liens against those assets and priority claims, the several classes of unsecured creditors will comprise the residual ownership class.

223. See id. § 1129(a)(7).
224. See supra note 209 and accompanying text.
225. As an alternative to designating the residual ownership class based on the liquidation analysis, there is a case to be made for designating all impaired creditors as residual owners, and requiring approval of the plan by a majority of all impaired claims that will not be canceled by the plan. Although a class may be impaired but not residual when the firm is valued by collapsing all future values to a present value, a creditor whose claim is neither cured and reinstated nor paid in full on the effective date of the plan arguably should be considered a residual claimant because it risks nonpayment of its restructured claim should the plan fail. The significant flaw of this approach is that a plan proponent might artificially impair creditors for the purpose of obtaining acceptance of the plan by a majority of impaired claims. Although artificial impairment could be prohibited, the incentive to do so will, as under the current section 1129(a)(10), create litigation on the question. See, e.g., cases cited supra note 205.


3. Agency Cost Problems with a Residual Owner Franchise

When residual owners hold other claims or interests with respect to a firm, they may cast their votes to advance those other interests instead of their residual ownership positions. Stated differently, residual owners with other claims or interests will not share gains or losses commensurate with their voting influence. Voting by residual owners with multiple interests introduces agency costs. For example, when residual owners of an insolvent debtor are also managers, they may vote their claims to advance their interests as managers. Managers may favor deployment decisions that other residual owners oppose because they would protect the managers' interests. Accordingly, as under section 1129(a)(10) of the current Code, insider votes should be excluded from the residual owner franchise. (It should be noted, however, that this exclusion itself introduces agency costs because the remaining, noninsider claimants will not reap the full benefits nor incur the full costs of their decisions; the excluded insiders will enjoy some of the benefits and incur their proportionate share of the costs of the decisions.)

A related issue concerns the majority required for acceptance of the plan by the residual owner class. Under the present Code, acceptance requires the affirmative vote of at least two-thirds in amount and one-half in number of the claims in the class.\(^\text{226}\) This supermajority voting standard may be appropriate with respect to class decisions on whether to waive the class members' entitlements under the absolute priority rule,\(^\text{227}\) but imposes agency costs when applied to deployment decisions by the residual owner class; the supermajority voting standard is a departure from a one vote per share standard that permits a minority of claims to decide the rights of all members of the class. It generates potential agency costs because a minority who do not receive benefits or losses coextensively with their voting power may cause rejection of the plan.\(^\text{228}\) The standard for approval of a plan by the residual class should be a simple majority so that economic consequences are aligned with voting influence.

4. The Collective Action Problem

The collective action problem will not obviate a requirement for residual owner approval of a plan. Although in many cases a diffusion of claims and managers' information advantages may leave residual

\(^{226}\) See 11 U.S.C. § 1126(c).

\(^{227}\) See id. § 1129(a)(8), (b). See supra notes 158-66 and accompanying text.

\(^{228}\) See Easterbrook & Fischel, supra note 14, at 408-10; see also Skeel, supra note 6, at 489-90 (arguing that a simple majority vote standard should be applied to class votes pursuant to section 1129(a)(8)).
owners without an economic incentive to become informed and vote on a plan, a residual owner franchise in Chapter 11, as under state law, will promote efficiency at the margins. The works of Fischel and Easterbrook and Skeel have convincingly shown that the shareholder franchise persists as the core feature of corporate governance outside of bankruptcy because it reduces agency costs of the separation of ownership and control.\textsuperscript{229}

Moreover, the collective action problem may be less acute in Chapter 11 for several reasons. First, the Code provisions for creditors' committees ease the problem by providing for representation of unsecured creditors at the estate's expense by a committee composed of the largest unsecured claim holders.\textsuperscript{230} (As noted above, however, creditors' committees are generally organized only in large cases, and unsecured creditors are not always the residual owners.) Second, no collective action problem exists in cases involving a primary, undersecured creditor. Here, a single creditor is the residual owner, and a diffusion of small claims obviously does not impede the residual owner from casting an informed vote on the plan. Finally, the growing market for trading claims and for corporate control in bankrupt firms increases claims aggregation and diminishes the collective action problem.

5. Revising Section 1129(a)(10)

This Article's analysis of the relationship between agency costs and voting under state law and federal bankruptcy law leads to the conclusion that part of the response to the dilemma of DIP control in Chapter 11 is to require residual owner approval as a condition to confirmation of a plan. Although Congress may have intended in section 1129(a)(10) to impose such a requirement, the statute has proved unequal to the task. Contrary to the calls for repeal of the provision,\textsuperscript{231} this Article argues for amending the provision so that it in fact requires residual owner approval of a plan. The Code should require acceptance of a plan by the class (or classes) of impaired claim or equity interest holders that, based on the liquidation analysis required by section 1129(a)(7), would receive partial payment if the firm were liquidated. As thus amended, the provision would avoid the artificial classification and artificial impairment problems that have plagued the current section 1129(a)(10). It would also permit equity holders to control the asset deployment decisions when the firm is solvent; under the current section 1129(a)(10), a plan must be accepted

\textsuperscript{229} See Easterbrook & Fischel, supra note 14, at 406-08; Skeel, supra note 6, at 519-33.
\textsuperscript{230} See Skeel, supra note 6, at 525-30.
\textsuperscript{231} See supra note 10.
In order to minimize agency costs, the vote should exclude insiders, as under the current provision. Unlike the present statute, a revised statute should avoid reintroducing agency costs by requiring acceptance by only a simple majority in amount of the claims or interests in the class(es).

VI. CONCLUSION

The central dilemma in Chapter 11 is that the managers who have primary authority for asset deployment decisions generally lack the appropriate incentives to make efficient decisions. Chapter 11 generally leaves the prebankruptcy managers in control of the firm but does not adequately constrain their authority to act contrary to the interests of the firm. In the normal nonbankruptcy operation of a firm, the shareholder franchise acts as a significant limitation on the discretion of managers. The right to vote is the right to make all decisions not otherwise specified by contract, and shareholders hold the franchise because they are the residual owners of a solvent company and, therefore, possess the proper incentives to maximize firm value. Under the current bankruptcy regime, there is no effective parallel limitation on the DIP. Congress probably intended section 1129(a)(10) to require residual owner approval for a reorganization plan, but unartfully drafted the provision and consequently the courts have not correctly or consistently interpreted it. By giving the residual owners authority to approve a proposed plan, Chapter 11 will take an important step toward more effectively constraining the agency costs of DIP control.