A NEW APPROACH TO CORPORATE REORGANIZATIONS

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In this Article, Professor Bebchuk proposes a new method of dividing the reorganization pie among the participants in corporate reorganizations. This method, he argues, can address the substantial efficiency and fairness problems that afflict the existing process of division. Under the proposed method, participants will receive certain rights with respect to the reorganized company's securities; these rights will be designed so that, whatever the reorganization value is, no participant will have a basis for complaining that he is receiving less than the value to which he is entitled. Although Professor Bebchuk proposes the method as a basis for law reform, he shows that it also can be used under the existing reorganization rules.

I. INTRODUCTION

THE concern of this Article is the way in which corporate reorganizations divide the reorganization pie. The Article puts forward a new method for making the necessary division. This method can address some major efficiency and fairness problems long thought to be inherent in corporate reorganizations. Although the method is proposed as a basis for law reform, it can also be used under the existing rules.

Reorganization is one of the two routes that a corporation in bankruptcy may take. When a corporation becomes insolvent and bankruptcy proceedings are commenced, the corporation is either liquidated or reorganized. In liquidation, which is governed by chapter 7 of the Bankruptcy Code,[1] the assets of the corporation are sold, either piecemeal or as a going concern. The proceeds from this sale are then divided among those who have rights against the corporation, with the division made according to the ranking of these rights.

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A mathematical derivation of all the elements of this Article's analysis is included in the discussion paper version of the Article, which was issued as Discussion Paper #37, January 1988, Program in Law and Economics, Harvard Law School.

[1] 11 U.S.C. §§ 701–786 (1982 & Supp. IV 1986).

Reorganization, which is governed by chapter 11 of the Bankruptcy Code,[2] is an alternative to liquidation. Reorganization is essentially a sale of a company to the existing "participants" — all those who hold claims against or interests in the company. This "sale" is of course a hypothetical one. The participants pay for the company with their existing claims and interests; in exchange, they receive "tickets" in the reorganized company — that is, claims against or interests in this new entity.

Why is the reorganization alternative necessary? The rationale commonly offered is that a reorganization may enable the participants to capture a greater value than they can obtain in a liquidation.[3] In particular, reorganization is thought to be especially valuable when (i) the company's assets are worth much more as a going concern than if sold piecemeal, and (ii) there are few or even no outside buyers with both accurate information about the company and sufficient resources to acquire it. In such situations, liquidation might well leave the participants with less than the going-concern value of the company's assets; consequently, the participants will have more value to split if they retain the enterprise and divide it among themselves.

The development of U.S. Bankruptcy law in this century suggests that public officials have long believed that reorganization is indeed desirable in an important set of cases. In 1938, Congress adopted chapter X of the Chandler Act[4] to provide a detailed set of rules to govern reorganizations. Chapter 11 of the Bankruptcy Code replaced these rules in 1978.[5] Throughout this period, many corporations in financial distress, including major Fortune 500 corporations, have taken the reorganization route.[6]

This Article takes as given the existence (and significant use) of the reorganization alternative to liquidation. Professors Baird and Jackson have recently challenged the conventional wisdom that it is desirable to have the corporate reorganization alternative; in their view, it might well be desirable to eliminate the reorganization alternative and resort to liquidation in the case of each insolvent corporation.[7] This Article does not enter that debate. Although the Article

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[2] *Id.* §§ 1101–1174.

[3] *See, e.g.*, Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1252–54 (1981).

[4] Pub. L. No. 75-696, 52 Stat. 840 (1938) (repealed 1978). Earlier, Congress had amended the Bankruptcy Act of 1898, 30 Stat. 544, by adopting section 77, 47 Stat. 1467, 1474–82 (1933), to govern railroad reorganizations, and section 77B, 48 Stat. 912, 912–22 (1934), to govern other reorganizations.

[5] *See* The Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1101–1174 (1982 & Supp. IV 1986).

[6] *See, e.g.*, *LTV Corp. Files for Bankruptcy: Debt is $4 Billion*, N.Y. Times, July 18, 1986, at A1, col. 1. At the time of filing, LTV was ranked as the 43rd largest industrial company in the U.S. *See id.* at D4, col. 1.

[7] *See* T. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY ch. 9 (1986); Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

seeks to improve the reorganization process, it does not advance, or indeed take any position on, the proposition that having reorganizations is desirable. Rather, it advances only the proposition that as long as reorganizations remain, the best method for dividing the reorganization pie is the one put forward below.

Part II of this Article briefly describes the problems that have long afflicted the division process in corporate reorganizations. Because no objective figure is generally available for the value of the reorganized enterprise, the law has consigned the division of the reorganization pie to a process of bargaining and litigation among the various classes of participants. This process of bargaining and litigation frequently results in substantial deviations from participants' entitlements, commonly involves significant delays and litigation costs, and often produces an inefficient capital structure for the reorganized company.

Part III describes the proposed method of dividing the reorganization pie. The new method involves no bargaining or litigation, nor does it require that the value of the reorganized company be identified. Under the method, the participants in a reorganization would receive a set of rights with respect to the securities of the reorganized company. These rights are designed so that, whatever the reorganization value, the participants will never end up with less than the value to which they are entitled.

Part IV demonstrates the perfect consistency of the method's outcome with the entitlements of all participants. In particular, I show that the method will be effective even if the market is inaccurate in pricing the value of the rights distributed to the participants. Whether or not the market's pricing is accurate, no participant will have a justifiable basis for complaining about the method's outcome.

Part V discusses the implementation of the proposed method. Reorganization law, I suggest, should be reformed to facilitate and require use of the method in every corporate reorganization. Under such a regime, the division process will be effected swiftly, fairly, and efficiently. Moreover, the proposed method can be used even under the existing rules. Some participants will likely find it in their interest to use the method as a basis for reorganization plans filed for confirmation under the existing rules.

In describing the operation and effectiveness of the proposed method, Parts III and IV use a simple example for convenience of exposition. Part VI shows how the proposed method can be adapted to deal with complex real-world features that are not present in that example.

II. The Division Problem in Corporate Reorganization

The division problem in corporate reorganization, on which this Article focuses, may be stated briefly as follows. Given the set of all

claims by participants, each claim defined by its size and relative priority, how should the reorganization pie (that is, the value of the reorganized company) be divided among the participants?

It is true that this issue of division, although central, is not the only element in corporate reorganizations. A reorganization inevitably must also include the preliminary process of determining the size and relative priority of the participants' claims. For example, it might be necessary to determine the amount the company owes to the holders of a certain bond issue or to certain business partners, as well as the relative priorities of these debts. Although this preliminary, inevitable process of determining the size and ranking of claims often involves significant delay and litigation costs, I will not discuss it. Rather, I will focus on the division problem, and to this end I will largely assume that the size and ranking of the participants' claims are already known.

As explained below, the existing reorganization process resolves the problem of division in a way that suffers from substantial imperfections. These imperfections are all rooted in a problem of valuation. It is generally impossible to place an objective and indisputable figure on the value that the reorganized company will have (the "reorganization value").[8] If such a figure were available, the distribution of tickets in the reorganized company would be easy to determine. Without such a figure, however, it is difficult to decide where, down the rank of creditors and preferred shareholders, it is necessary to stop issuing tickets in the newly reorganized entity.

This problem of valuation obviously does not exist in a liquidation, when actual sale to an outsider takes place. The liquidation results in an exchange of the company's assets for cash (or cash equivalents, such as marketable securities). Whether or not this cash represents the true value of the assets sold, there is no question as to the monetary value of the total pie available for distribution. The receiver running the liquidation thus can start by paying creditors that are most senior, until either no money is left or their claims are paid in full; the receiver then will pay money to creditors in the next tier, again until no money is left or their claims are paid in full; and the receiver will continue in this fashion until all the money runs out.

In contrast to liquidation, the sale of the company's assets in a reorganization is fictional. Consequently, no objective figure is available for the total monetary value to be distributed or, as a result, for the monetary value of the various tickets in the reorganized company. Although agreement over this reorganization value would be hard to achieve even among impartial observers, the clear conflict of interest

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[8] *See, e.g.* Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 547–48 (1983).

among the participants makes it all the more difficult. Senior creditors have an incentive to advance a low valuation, because a low valuation would entitle them to a larger fraction of the tickets in the reorganized company.[9] For a similar reason, equityholders have an incentive to advance a high valuation.[10] It is of course possible to ask courts to estimate the reorganization value, and courts indeed sometimes must make such estimates. But no one suggests that we can rely on such judicial estimates to be generally accurate.[11]

The law has always dealt with this valuation problem by leaving the division of tickets in the reorganized company to a process of bargaining among the participants.[12] The law has sought only to provide a set-up for this bargaining and to establish constraints within which the division must take place. Under existing rules, a plan of reorganization generally will obtain judicial confirmation if all the classes of participants approve it.[13] The legal rules governing this approval process prescribe how participants may be grouped into classes, how their votes are to be solicited, and what majority counts as class approval.[14] The rules constrain the bargaining process by prescribing the limits within which the classes may bargain. In particular, the rules limit the concessions that a class may elect to make: the class may vote to make concessions but it may not, without unanimous agreement among the members of the class, concede to receive less than the class would get in a liquidation.[15] Similarly, the rules also limit the amount that a class can hope to extract in conces-

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[9] Suppose, for example, that the senior creditors are owed $100 and that the reorganized company will have 100 common shares. Then, if the value of the reorganized company is determined to be $100, the senior creditors will be entitled to all of the reorganized company's shares. But if the value is determined to be $1000, then the senior creditors will be entitled to only 10% of the company's shares.

[10] For example, imagine that the company owes $100 to all of the creditors and that the reorganized company will have 100 common shares. Then, if the value of the reorganized company is determined to be $100, the equityholders will be entitled to nothing. But if the value is determined to be $1000, the equityholders will be entitled to 90% of the company's shares.

[11] The difficulties involved in judicial estimates of a reorganized company's value are apparent to any reader of cases in which judges have to make such estimates. *See, e.g.*, *In re* King Resources Co., 651 F.2d 1326, 1335–38 (10th Cir. 1980); *In re* Evans Products Co., 65 Bankr. 870, 875–76 (S.D. Fla. 1986).

[12] For a description of the evolution of reorganization law in the last fifty years, see Coogan, *Confirmation of a Plan under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 303–05, 309–26 (1982).

[13] *See* 11 U.S.C. § 1129(a) (1982 & Supp. IV 1986). For a discussion of the conditions for confirming a reorganization plan, see Trost, *Business Reorganizations Under Chapter 11 of the New Bankruptcy Code*, 34 BUS. LAW. 1309, 1328–37 (1979).

[14] *See* 11 U.S.C. §§ 1122, 1125, 1126 (1982 & Supp. IV 1986); Coogan, *supra* note 12, at 328–36.

[15] This limitation arises from the "best interest of the creditors" test established by 11 U.S.C. § 1129(a)(7) (1982). *See* Coogan, *supra* note 12, at 344–45.

sions from other classes: a plan will be confirmed in spite of the objection of a class if it can be shown that the value the class is receiving meets a certain standard.[16]

This process of bargaining and litigation is quite imperfect. First, and most importantly, the reorganization process often produces a division that substantially deviates from the participants' entitlements. Sometimes the deviation is unintentional, the result of inaccurate evaluation. Sometimes the deviation is deliberate: participants might use their power to delay in order to extract a reorganization plan that gives them more than the value to which they are entitled. For example, equityholders, it is generally believed, often use their delaying power to extract a substantial value even in instances in which the creditors are entitled to all of the reorganization value.[17]

Second, the reorganization process often results in the choice of an inefficient capital structure for the reorganized company. The company's capital structure should be chosen solely to maximize the reorganized company's value. But under the existing system, the choice of the capital structure is often substantially affected by various strategic factors.[18]

Third, putting aside the severe shortcomings of the outcome of the division process, the process itself has substantial costs. The process usually involves significant litigation costs and frequently produces delay (beyond the time necessary to determine the size and ranking of the participants' claims). This delay might result from a genuine failure of the participants to reach an agreement, but it also might be caused deliberately by some participants whose interest would be served by a postponement.[19] The resulting delay commonly involves significant costs, some obvious and some subtle. For one thing, the company usually cannot function efficiently during the reorganization period.[20]

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[16] A court will approve a plan over the objection of a class if the value given to the class satisfies the "absolute priority" standard. This possibility is established by the "cramdown" provision of 11 U.S.C. § 1129(b) (1982). *See* Coogan, *supra* note 12, at 352–57.

[17] *See, e.g.*, Trost, *Corporate Bankruptcy Reorganization: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 550 (1973).

[18] For a discussion of the ways in which strategic factors shape the choice of the capital structure, see Roe, cited in note 8 above, at 536–46.

[19] In particular, a delay often might be in the interest of equityholders. When the value of the reorganized company is lower than the total value of creditors' claims, the equityholders might have nothing to lose and something to gain from a delay.

[20] Potential business partners, for example, might be reluctant to do business with the company or might be willing to conduct business only on special terms. Furthermore, management decisions during the reorganization period are afflicted with serious conflict-of-interest problems. The company is usually run by the pre-reorganization management, which represents the equityholders. The interests of the equityholders in an insolvent corporation are likely to be served by courses of action that may not be value maximizing. For example, it likely will be in the interest of the equityholders for the company to take risks, even if taking such risks

Observers of the corporate reorganization process have long been painfully aware of its substantial imperfections.[21] In 1978, Congress tried to alleviate some of the widely perceived problems by making significant changes in reorganization law. The 1978 changes, for example, sought to provide more room for bargaining by giving classes the power to make greater concessions to each other.[22] It is unclear, however, whether the changes have made matters better or worse. Whether or not the new rules are an improvement, there seems to be a consensus on one thing — that although the division process can perhaps be improved, it is bound to remain significantly imperfect, because of the impossibility of accurate judicial valuation and the inevitable shortcomings of bargaining and litigation.[23]

Indeed, this perception concerning the inherent imperfection of the division process in reorganizations has been the main basis for the view, recently expressed by Professors Baird and Jackson, that it might be desirable to eliminate the reorganization alternative altogether and resort only to liquidation.[24] As explained below, however, this perception is wrong: the reorganization process can be greatly improved.

III. The Proposed Method

A. The Example

To describe and assess the proposed method, it will be useful to consider it in the context of a concrete and simple example. Consider a publicly traded company that has three classes of participants. Class *A* includes 100 senior creditors, each owed $1. Class *B* includes 100

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would not be value maximizing. Taking a risky course of action will likely benefit the equityholders of an insolvent corporation, because they might well have little to lose from a downward turn in the company's fortunes and more to gain from an upward turn.

[21] *See, e.g.*, D. Baird & T. Jackson, Cases, Problems, and Materials on Bankruptcy Ch. 9 (1985); Blum, *The Law and Language of Corporate Reorganization*, 17 U. Chi. L. Rev. 565, 571–72 (1950); Brudney, *The Investment-Value Doctrine and Corporate Readjustments*, 72 Harv. L. Rev. 645 (1959); Roe, *supra* note 8, at 536–49.

[22] For a discussion and assessment of the 1978 changes, see Coogan, cited in note 12 above, and Trost, cited in note 13 above.

[23] Indeed, the perception that the division process is inherently imperfect is held even by Professor Roe, who has put forward an important proposal for reforming the process. *See* Roe, *supra* note 8. Although Roe's proposal would in my view be a substantial improvement over the existing process, it would not perform as well as the method proposed in this Article. *See infra* p. 790.

[24] *See* T. Jackson, *supra* note 7, ch. 9; Baird, *supra* note 7, at 127–48.

junior creditors, each owed $1. Class C includes 100 equityholders, each holding one unit of equity.[25]

The company is now in bankruptcy proceedings and is to be reorganized. The Reorganized Company, which I will call RC, is going to have a capital structure that for now I will assume to be given. For any chosen capital structure, it is of course possible to divide the securities of RC into 100 equal units. For example, if RC will have 100 shares of common stock and 50 shares of preferred stock, then each of the 100 RC units will consist of 1 common share and 1/2 preferred share. The question for the reorganization process is how to divide the 100 units of RC among the three classes of participants.

B. Dividing the Pie Supposing its Size is Known

Let us denote the value of the reorganized company RC as V per unit. Thus, $100V$ is the total size of the pie to be distributed. As already noted, the division of the pie would be a straightforward matter if we could measure its size exactly (that is, if we could estimate V with precision). In such a case, we would simply proceed according to the ranking of the various classes involved.

Consider first the case in which the figure placed on V is no higher than $1. In this case, the total pie is no greater than $100, which is the full value of class A's claims. Therefore, all the 100 units of RC should be given to the senior creditors (and divided among them pro rata).

Consider next the case in which the figure placed on V is greater than $1 but no greater than $2. In this case, the total pie is no greater than $200, which is the full value of the claims of the senior and junior creditors, and it thus should be divided only among the creditors. Because there is enough to pay the senior creditors in full, they should receive a value of $100, which can be accomplished by giving them $100/V$ units. Dividing these units among senior creditors pro rata, each senior creditor would receive $1/V$ units worth $1. The junior creditors should receive the remaining value of $100V - \$100$, which can be accomplished by giving them the remaining $100 - (100/V)$ units. Dividing these units among the junior creditors, each would end up with $1 - (1/V)$ units.[26]

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[25] As will be apparent, the method would also apply well to companies whose stock is not publicly traded, because the method's effectiveness does not hinge on the presence of market trading. Similarly, the other simplifying features of the example are not essential for the method's effectiveness. In particular, Part VI will show how the method might be adapted to situations in which the company has more than three classes of participants, secured creditors, and/or a class whose claims are concentrated in one hand.

[26] For example, if V is $1.25, then class A should receive 80 shares (100/1.25), with each senior creditor receiving 0.8 shares; and class B should receive 20 shares (100 − 100/1.25), with each junior creditor receiving 0.2 shares.

Finally, consider the case in which the figure placed on V is higher than \$2. In this case, there is more than enough to pay both class A and class B in full. To be paid in full, the senior creditors as a class should receive $100/V$ units, with each senior creditor getting $1/V$ units. The junior creditors, also paid in full, should also receive $100/V$ units total, or $1/V$ units each. And the equityholders should receive the remaining value of $100V - \$200$. This would be accomplished by giving them — and dividing among them pro rata — the remaining $100 - (200/V)$ units (that is, $1 - (2/V)$ units for each equityholder).[27]

The conclusions of the above analysis — showing how the reorganization pie should be divided if we could measure V precisely — are summarized in Table 1 below.[28]

TABLE 1

DISTRIBUTION OF UNITS SUPPOSING V IS KNOWN

Value of V	Distribution of Units	
$V \leq 1$	Senior Creditors:	1 unit each (worth V)
	Junior Creditors:	nothing
	Equityholders:	nothing
$1 < V \leq 2$	Senior Creditors:	$1/V$ unit each (worth \$1)
	Junior Creditors:	$1 - (1/V)$ unit each (worth $V - \$1$)
	Equityholders:	nothing
$V > 2$	Senior Creditors:	$1/V$ unit each (worth \$1)
	Junior Creditors:	$1/V$ unit each (worth \$1)
	Equityholders:	$1 - (2/V)$ unit each (worth $V - \$2$)

27 For example, if V is \$2.50, then the senior creditors should get 40 shares (0.40 shares each), the junior creditors should get 40 shares (0.40 shares each), and the equityholders should get 20 shares (0.20 shares each).

28 Another way of expressing participants' entitlements as a function of V is by using the mathematical notation min(., .) and max(., .). (This notation has the following meaning: $\min(x, y)$ denotes the smaller of the values x and y; similarly, $\max(x, y)$ denotes the greater of the values x and y.)

As we have seen, a senior creditor is entitled to receive the smaller of (i) \$1, the full value of his claim, and (ii) V, his pro rata share of the reorganization value. Thus, a senior creditor is entitled to $\min(\$1, V)$.

A junior creditor is entitled to receive no less than the smaller of (i) \$1, the full value of his claim, and (ii) his pro rata share of the value left, if any, after the senior creditors are paid in full, which is $\max(0, V - \$1)$. Thus, the junior creditor is entitled to $\min(\$1, \max(0, V - \$1))$.

Finally, an equityholder is entitled to no less than his pro rata share of the value left, if

C. *Participants' Entitlements as a Function of Reorganization Value*

The question of division thus would pose no problem if we could measure V with precision. As already emphasized, however, the value of V — and thus also the monetary value to which each participant is entitled — cannot be determined with indisputable accuracy. But even though we cannot identify precisely the value to which each participant is entitled, we can precisely express this value as a function of V, the reorganized company's per unit value.

Consider first the senior creditors. As the analysis above has shown, a senior creditor is entitled to a value of V if $V \leq \$1$ and a value of \$1 if $V > \$1$. Alternatively put, a senior creditor is entitled to a value of \$1 unless the reorganization value is less than \$100, in which case the senior creditor is entitled to his pro rata share of the reorganization value (that is, to one unit of *RC*).

Consider next the junior creditors. A junior creditor, we have seen, is entitled to nothing if $V \leq \$1$, is entitled to $V - \$1$ if $\$1 < V \leq \$2$, and is entitled to \$1 if $V > \$2$. Alternatively put, a junior creditor is entitled to a value of \$1 unless the reorganization value is less than \$200, in which case he is entitled to his pro rata share of the value that is left, if any, after the senior creditors are paid in full.

Finally, an equityholder is entitled to nothing if $V \leq \$2$, and to $V - \$2$ if $V > \$2$. Alternatively put, an equityholder is entitled to his pro rata share of the value that is left, if any, after the senior and junior creditors are paid in full.

Table 2 below summarizes these conclusions concerning participants' entitlements as a function of the reorganization value.

TABLE 2

PARTICIPANTS' ENTITLEMENTS AS A FUNCTION OF V

	$V \leq \$1$	$\$1 < V \leq \$2$	$V > \$2$
Senior Creditor	V	\$1	\$1
Junior Creditor	0	$V - \$1$	\$1
Equityholder	0	0	$V - \$2$
TOTAL	V	V	V

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any, after the senior and junior creditors are paid in full. Thus, the equityholder is entitled to $\max(0, V - \$2)$.

To summarize, the participants' entitlements are as follows:

Senior Creditors: $\min(\$1, V)$
Junior Creditors: $\min(\$1, \max(0, V - \$1))$
Equityholders: $\max(0, V - \$2)$.

D. The Proposed Approach

The idea underlying the proposed method is simple. Even though we do not know V and consequently do not know the value of participants' entitlements in terms of dollars or RC units, we do know precisely what participants are entitled to as a function of V (that is, for any value that V might take). With this knowledge, it is possible to design and to distribute to the participants a set of rights concerning RC's units such that, for any value that V might take, these rights would provide participants with values perfectly consistent with their entitlements.

Before describing the proposed approach, a preliminary remark on implementation is in order. As will be seen presently, each of the rights distributed to participants will have an "option" component.[29] In principle, the options should be for immediate exercise. However, because the participants might need a little bit of time to understand the terms of the options given to them, it might well be desirable to provide them with such time. The exercise date of the options, then, will be shortly after the distribution of the rights. For concreteness, I will assume below that the reorganized company will start its life and distribute the rights to participants on January 1; and that the exercise date for all the rights distributed will be four days later, on January 5.

Thus, on January 1, the reorganized company will start its life. But, under the proposed method, the units of RC will not be distributed at this point but rather will be retained by the company until January 5. Instead of receiving RC units, on January 1 the participants will get the following rights with respect to RC units.

1. Senior Creditors. — Each senior creditor will receive one type-A right. A type-A right may be redeemed by the company on January 5 for \$1. If the right is not redeemed, its holder on January 5 will be entitled to receive one unit of RC.[30]

To get some sense at this stage of the value to senior creditors of receiving type-A rights, consider a creditor that holds his type-A right until January 5. If the right is redeemed, then the creditor will be paid in full. If the right is not redeemed, then the creditor will receive a value of V. And indeed, the senior creditor is never entitled to receive more than either \$1 or V (see Table 2).

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[29] As economists have recognized, it is often useful to break a security into its option components. Many securities can be described usefully as a set of certain options with respect to the assets of the issuing firm. *See, e.g.*, R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE chs. 20, 23 (2d ed. 1984).

[30] In the terminology of options, a type-A right is equivalent to the following position: having one (call) option on one RC unit with an exercise price of \$0, plus being short one (call) option on one RC unit with an exercise price of \$1.

2. *Junior Creditors.* — Each junior creditor will receive a type-B right. The company may redeem a type-B right on January 5 for \$1. If the right is not redeemed, its holder will have the option on January 5 to purchase one unit of RC for \$1. To exercise this option, the holder of the right must submit it to the company by January 5 accompanied by a payment of the \$1 exercise price.[31]

Again, it might be worthwhile to describe briefly how receiving a type-B right will provide a junior creditor with the value to which he is entitled. If the creditor holds on to the type-B right and the right is redeemed, then the creditor will be paid in full. If the right is not redeemed, exercising it will provide the creditor with a value of $V - \$1$. And indeed, the creditor is never entitled to receive a value higher than both \$1 and $V - \$1$ (see Table 2).

3. *Equityholders.* — Each equityholder will receive one type-C right. A type-C right may not be redeemed by the company. The holder of a type-C right will have the option to purchase one RC unit on January 5 for \$2. To exercise this option, the holder must submit the right to the company by January 5 accompanied by a payment of the \$2 exercise price.[32]

Note that if an equityholder holds on to his right until January 5 and then chooses to exercise it, he will get a value $V - \$2$. And indeed, the equityholder is never entitled to a positive value exceeding $V - \$2$ (see Table 2).

These three types of rights will all be transferable. Thus, between January 1 and January 5, there will presumably be public trading in the rights. A participant that is given any one of the rights may thus either sell it on the market or retain it until the exercise date of January 5.

Table 3 below summarizes the terms of the rights to be distributed to participants.

E. The Exercise of Rights

Adding up the obligations that RC will have toward the holders of type-A, type-B, and type-C rights shows that the net obligation of RC is to distribute 100 RC units on January 5, which is exactly what is available for distribution. Thus, RC should have no problem meeting all its obligations toward the holders of the three types of rights. Nonetheless, it is worth going through the mechanics of the process in detail.

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[31] In the terminology of options, one type-B right is equivalent to the following position: having one (call) option on one RC unit with an exercise price of \$1, plus being short one (call) option on one RC unit with an exercise price of \$2. If the option on which the holder is short is not exercised, he will simply end up with an option to purchase one RC unit for \$1. If the option on which the holder is short is exercised, he will end up with \$1 (purchasing one RC unit for \$1 and selling it for \$2).

[32] In the terminology of options, one type-C right is equivalent to one (call) option on one RC unit with an exercise price of \$2.

TABLE 3

THE DISTRIBUTION OF RIGHTS

Senior Creditors
Each senior creditor receives one type-*A* right. A type-*A* right may be redeemed by the company on January 5 for $1. If the right is not redeemed, on January 5 its holder will be entitled to receive one unit of *RC*.
Junior Creditors
Each junior creditor receives one type-*B* right. A type-*B* right may be redeemed by the company on January 5 for $1. If the right is not redeemed, on January 5 its holder will have the option to purchase one unit of *RC* for $1.
Equityholders
Each equityholder receives one type-*C* right. A type-*C* right may not be redeemed by the company. The holder of such a right on January 5 will have the option to purchase one unit of *RC* for $2.

Suppose first that all of the holders of type-*C* rights wish to exercise their options to buy *RC* units and that they submit a total of $200 to the company. *RC* then will provide them with all 100 units of *RC* (one unit for each right submitted), and it will use the $200 received from them to redeem all of the type-*A* and type-*B* rights.

Suppose now that no type-*C* rights are submitted for exercise, but that all holders of type-*B* rights wish to exercise their options to buy *RC* units at $1 and therefore submit a total of $100 to the company. In this case, *RC* will give all of the *RC* units to the holders of these type-*B* rights, and it will use the $100 received from them to redeem all of the type-*A* rights.

Next, suppose that no type-*B* or type-*C* rights are submitted for exercise. The mechanics of this case will be simpler still: the 100 units of *RC* will be distributed to the holders of type-*A* rights (one *RC* unit per right).

Finally, it remains to consider situations in which only a fraction of the type-*B* or type-*C* rights are submitted for exercise. Such situations are unlikely to arise if there is public trading in the rights.[33]

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[33] To see why such situtations are unlikely, imagine for example that as January 5 arrives, some holders of type-*B* rights (the "optimists") submit the rights for exercise while other holders of type-*B* rights (the "pessimists") do not submit their rights. The optimists' behavior indicates that they believe that *V* exceeds $1. The pessimists, as long as they do not intend to use their rights in any way, should be happy to sell them for any negligible positive price. Thus, as long

But in any event, given the design of the rights — in particular, the fact that the total net obligation of the company toward all right holders is to distribute 100 units of *RC* — such situations will present no special problem for the execution process.

For example, suppose that only 50 type-*B* rights (and presumably no type-*C* rights)[34] are submitted for exercise. Then, those who submitted type-*B* rights will receive 50 units of *RC* (one unit per submitted right). The $50 submitted by them will be used for pro rata redemption of type-*A* rights. Consequently, each holder of a type-*A* right will end up with $0.50 and 0.50 units of *RC*.

More generally, *RC* will proceed in situations of partial submission of rights as follows. The money received from the exercise of type-*C* rights will be used half for pro rata redemption of type-*A* rights and half for pro rata redemption of type-*B* rights. The money received from the exercise of (unredeemed and submitted) type-*B* rights will be used for pro rata redemption of type-*A* rights. The 100 *RC* units will be given to those submitting type-*C* rights, those submitting type-*B* rights that are not going to be redeemed, and those holding type-*A* rights that are not going to be redeemed.[35]

IV. Consistency with Participants' Entitlements

This Part demonstrates that the outcome of the proposed method of division will be perfectly consistent with the entitlements of the

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as some shares are held by pessimists who are not going to use them, the market price of type-*B* rights must be negligible. But at such a market price, the optimists would buy the rights and submit them to the company for exercise. Alternatively put, if the optimists, but not the pessimists, view the rights as having some value and use, then, in the presence of market trading, the rights should all end up at the hands of the optimists, who would use them; no rights would remain idle in the hands of pessimists to whom the rights are of no use.

[34] If some type-*B* rights are not submitted for exercise, then the market price of such rights must be negligible. In such a case, no holder of a type-*C* right will have a reason to submit it. If the holder did submit a type-*C* right, he would have to pay $2 to get one *RC* unit. Therefore, even if the holder does believe that *V* exceeds $2, he will still be better off not using his type-*C* right but instead purchasing a type-*B* right for the negligible market price, and then using this right to purchase an *RC* unit for only $1.

[35] To consider a more complex example than the one above, suppose that only 50 type-*C* rights and all of the type-*B* rights are submitted for exercise. Those who submitted type-*C* rights will receive 50 *RC* units. The $100 received from them will be used for a pro rata redemption of 50 type-*A* and 50 type-*B* rights: each holder of a type-*A* or a type-*B* right will have half of his right redeemed. The 50 remaining *RC* units will be divided among the holders of the 50 unredeemed, submitted type-*B* rights. The $50 received by the company from the exercise of these 50 type-*B* rights will be used to redeem the remaining 50 type-*A* rights. In sum, the units of *RC* will end up half in the hands of those submitting type-*C* rights and half in the hands of those holding type-*B* rights.

participants. As emphasized earlier, the problems of the division process arise from the difficulties involved in determining the monetary value of the reorganized company. The proposed method, however, makes no attempt to estimate this monetary value, nor does it require even a rough sense of the monetary value of the rights that the participants will receive. Although we may not know how much these rights are worth, we can be confident that whatever their worth is, they will provide the receiving participants with no less than the value to which they are entitled.

A. The Significance of Not Relying on Accurate Market Pricing

The rights given to the participants will be traded on the market in the brief period between the issue date and the exercise date. As the analysis below will indicate, if the market does not underestimate the reorganized company's value, then the market price of any type of right will be no less than the value to which the participants receiving the right are entitled; consequently, the participants will be able to capture the value of their entitlement by immediately selling their rights on the market. Thus, the conclusion concerning the method's effectiveness follows immediately if one assumes that the market will not undervalue the distributed rights. As this Part shows, however, such an assumption is not necessary to reach this conclusion: the method's effectiveness does not hinge on the market's not undervaluing the rights or even on the presence of market trading in the rights.

This feature of the method is very important. Many may believe that capital market prices are efficient not only in most cases but also in the particular case of companies in financial distress. But whatever one's views on the merits of this question, one must recognize that many public officials and commentators believe that the market often errs (and usually in the direction of undervaluation) in appraising the value of companies that emerge out of reorganization.[36] Indeed, the primary rationale for the existence of the reorganization alternative to liquidation is the concern that the market often undervalues such companies; if the market could be relied on to price such companies perfectly, there would be no reason to expect that a reorganization would ever provide the participants with a greater value than they would get from a going-concern sale effected through a chapter 7 liquidation proceeding. Thus, any examination of the best reorganization method should take into account the concern that the market's estimate might be inaccurate. It is therefore a significant advantage

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[36] *See, e.g.*, Citibank, N.A. v. Baer, 651 F.2d 1341, 1347–48 (10th Cir. 1980); *In re* Interstate Stores, Inc., SEC Corporate Reorganization Release No. 322, 13 S.E.C. Docket 757, 786–87 (1977); Blum, *supra* note 21, at 566–67; Brudney, *supra* note 21, at 673–75.

of the proposed method that an inaccurate market pricing of the rights will not provide participants with a basis for objecting to the method's outcome.

This feature of the method is the main reason why it is superior to the method of division put forward by Professor Roe five years ago.[37] Roe was the first to seek, as I do in this Article, a method of division that would not be based on the problematic process of bargaining among the various classes of participants. He proposed to estimate the value of the reorganized company by selling ten percent of the reorganized company's securities on the market and then extrapolating the company's value from the sale price for these securities. Although Roe's method is, in my view, superior to the existing process of bargaining among classes, the method's reliance on market pricing makes it, as Roe himself recognized,[38] substantially imperfect. First, the method does not address the concerns of those who believe that the market might not perceive accurately the value of companies in reorganization. Second, even if the market's perceptions are accurate, selling a sample of the company's securities might produce an inaccurate figure, because some participants will have an incentive to manipulate the sale price. Third, Roe's method is inapplicable to companies whose securities are not publicly traded. Because the method that I propose does not hinge on the existence of accurate market pricing, it does not suffer from any of these problems.

Before proceeding to a detailed demonstration, it is worth stating briefly why accurate market pricing of the rights is not essential for the proposed method's effectiveness. Although participants may sell their rights on the market, they can always choose to retain them until the exercise date. If they do so, then, as is shown below, they will not end up with less than the value to which they are entitled. Consequently, even assuming that a given participant does not have, or attaches no value to, the opportunity to sell his rights on the market, the participant will have no basis for complaining about the method's outcome.

B. The Outcome in the Example

To demonstrate the method's effectiveness, I wish first to show that, in the example used in Part III, no participant has any basis for complaining about the method's outcome. Consider first the senior creditors. If they retain the type-*A* rights given to them, they will end up in one of two positions. First, their rights may be redeemed for $100 (if the holders of the type-*B* or type-*C* rights choose to exercise them). In this case, the senior creditors surely cannot complain about

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[37] *See* Roe, *supra* note 8.

[38] *See id.* at 575–80.

the outcome, as their claims will be paid in full. Alternatively, the senior creditors' rights may not be redeemed, in which case the creditors will end up holding all 100 units of *RC*. Again, they will have no basis for complaining, for they will be getting the whole reorganization pie: there is nothing more that could be given to them.

Now, the senior creditors surely might be unhappy about the way in which the market assesses the value of *RC* units and therefore also the value of type-*A* rights. Suppose that the senior creditors believe *V* to be $0.90, and suppose that the market believes the value of *V* to be only $0.50. In this case, the senior creditors will not be able to sell their type-*A* rights for more than $0.50. Similarly, if and when they get the units of *RC*, they will be able to sell them for only $0.50. But the fact that others are unwilling to pay the senior creditors more than $0.50 for what in their view is worth $0.90 does not provide the senior creditors with a basis for complaining that the reorganization's outcome deprives them of the value to which they are entitled — for they will receive from the reorganization process all that there is to distribute. They can complain about the market ("oh, the market is not what it is supposed to be") but not about the method's way of dividing *RC* units among the participants.

Consider now the junior creditors. If the junior creditors do not sell their type-*B* rights, they can end up in one of two positions. First, their rights may be redeemed by the company at $1 per right (if the type-*C* rights are submitted for exercise). In this case, the junior creditors will be paid in full and clearly have no reason to complain. Alternatively, the junior creditors may end up with options to purchase *RC* units at $1 per unit. The value of these options is by definition not lower than the value to which the creditors are entitled — for the junior creditors are entitled to no more than the value that is left, if any, after the senior creditors are paid in full. And having the option to receive all of the reorganization pie by paying the senior creditors' prior $100 claim makes the above value accessible to the junior creditors.

Again, the junior creditors might be unhappy about the way in which the market assesses the value of *RC* units and thus the value of their type-*B* rights. Suppose for example that the junior creditors believe that *V* is $1.90 and that the value to which they are entitled is thus $90 (the reorganization value of $190 minus the senior creditors' claims of $100). Suppose further that the market estimates *V* at $1.50 and thus prices the junior creditors' type-*B* rights at $0.50. The junior creditors will have no basis for complaining that the rights given to them have a $50 value, which is less than the $90 to which they are entitled. It would be inconsistent for them to assert both (i) that *V* is $1.90 and they are thus entitled to $0.90 each, and (ii) that the value of their options is only $0.50 each. If *V* is $1.90, then the value of an option to buy an *RC* unit at $1 is $0.90; this value can be realized

simply by exercising the option. The junior creditors thus should not sell their type-*B* rights to the unappreciative market; if they do sell, they will have only themselves to blame.

Finally, consider the equityholders. If they do not sell their type-*C* rights, they will on the exercise date have options to purchase *RC* units at $2. These options will make accessible to them the very value to which they are entitled — which is all that is left, if anything, after the claims of the senior and junior creditors are paid in full.

Again, the equityholders may claim that the market undervalues the value of *RC* units and thus the value of their type-*C* rights. But then they should not sell their rights; rather they should retain and exercise them. Their perception (whether accurate or not) that such undervaluation takes place will provide them with no basis for complaining about the method's outcome — for reasons similar to those that have been discussed above with respect to the junior creditors.

C. A More General Defense

Having examined in detail the method's outcome in our example, I now wish to state in general terms why any given participant will have no basis for complaining that the method's outcome is inconsistent with his entitlement. Suppose first that a given participant retains the right distributed to him until the exercise date. For him to assert that he has received less than the value to which he is entitled, he has to assert either (i) that those above him in priority (or those who bought their rights) have received too much, or (ii) that those below him in priority (or those who bought their rights) have received too much.

Those below the participant in priority (or those who bought their rights) will be able to capture any value only if they pay in full all the claims of those above them — including the participant's own claim. Thus, the participant will never have a basis for complaining that he is receiving too little because those below him are getting too much.

Similarly, the participant will be unable to complain that those above him in priority (or those who bought their rights) are getting too much — that is, that they are paid more than in full. By exercising the option given to him, the participant can ensure that, as far as his pro rata share of the company is concerned, those above him will not get more than the full value of their claims. The option automatically makes accessible to him his pro rata share of the value left after the preceding claims are paid in full — and he is entitled to no more.[39]

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[39] To illustrate the above reasoning, consider the position of a junior creditor in our example. For the creditor to have a justifiable complaint, he must assert either that the senior creditors

Thus, assuming that the participant's right is not transferable and that he must retain it until the exercise date, he will not end up with less than the value of his entitlement. And, clearly, he cannot be made worse off by the ability to sell his right, if he so wishes, in the period preceding the exercise date: if he believes that the market undervalues his right, he need not sell but rather can retain his right until the exercise date. Indeed, the ability to sell may improve the participant's situation: if he believes that the market accurately prices his right or overvalues it, he presumably will benefit from having the opportunity to sell.

D. Addressing the Problem of Differing Estimates

An alternative way of explaining the proposed method's effectiveness is by showing how it addresses the valuation problem, which may be referred to as the problem of divergent estimates. Because no objective, indisputable figure is available for the reorganized company's value, participants may advance different estimates of this value. If the participants could all be expected to advance the same estimate, the question of division would be straightforward: their common estimate could be used to divide the reorganized company's securities. The division question is difficult only because participants may well differ in the estimates they advance. Such differences may result from either strategic manipulation or genuine disagreement.

1. Strategic Manipulation. — Under the existing method of division, even if all participants actually share the same estimate of the reorganized company's value, they may well have strategic reasons for advancing different estimates. In the bargaining between any class and the classes preceding it, the preceding classes have an incentive to advance a low estimate whereas the junior class has the opposite interest.

Suppose, for instance, that the junior creditors and the senior creditors in our example have the same estimate of V; and consider what estimates they will find it in their interest to advance during bargaining and litigation under the existing method of division. The senior creditors will generally find it in their interest to advance an estimate below the participants' common estimate, for a low value of V would entitle them to a larger fraction of RC's securities. The

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are getting too much or that the equityholders are getting too much. The junior creditor cannot complain that the equityholders are getting too much, because they will get something only in the event that the junior creditor's type-B right is redeemed, in which case he will be paid in full. Similarly, the junior creditor's possession of a type-B right should prevent him from complaining that the senior creditors are receiving too much — that is, more than \$100, the full value of their claims. For, by exercising his right, the junior creditor can ensure that, as far as his pro rata share of the company is concerned, the senior creditors will not receive more than the full value of their claims.

junior creditors will generally find it in their interest to advance an estimate exceeding the participants' common estimate, for a high value of V would entitle them to a larger fraction of *RC*'s securities.

Under the proposed method, however, no class will be able to benefit from strategic manipulation of estimates. The division of securities will in no way depend on what the participants or anyone else *claim* V is. The division depends only on what the participants *do* with their rights. And the participants' decisions whether to exercise their rights will necessarily reflect their true judgment concerning V. In particular, the junior creditors in our example will not be able to get any value simply by asserting that V exceeds \$1; the only way for them to get any value is by exercising their rights (which of course they will do only if they estimate V to exceed \$1). Similarly, the senior creditors will not be able to get a higher value by strategically advancing a low estimate of V; what they will end up with depends only on what the junior creditors elect to do with their rights.

2. *Genuine Disagreement.* — Strategic manipulation is not the only reason for the different estimates that parties may advance under the existing reorganization process. Parties also may differ in their estimates due to genuine disagreement. Such differences may exist not only among classes but also among the participants in any given class.

The proposed method addresses the possibility of different subjective estimates by enabling each participant to decide individually, based on his *own* estimate of the reorganized company's value, whether to exercise his rights. Consequently, each participant will get no less, and may indeed get more, than the value to which he believes he is entitled based on his *own* estimate of the reorganization value.

Consider, for instance, a junior creditor in our example. If the creditor believes that V is less than \$1, then the value of his entitlement based on his estimate of V is zero (see Table 2). If the creditor keeps his right, which he will have to do if the right's market price is zero, he will not exercise it and indeed will end up with no value. But if others are more optimistic and believe that V exceeds \$1, then the market price of type-*B* rights will be positive, and the creditor will be able to sell his right for this positive market price.

Next, suppose that the creditor believes that V is between \$1 and \$2 — \$1.50 for instance — and that he thus believes that the value of his entitlement is \$0.50 (see Table 2). By retaining and exercising his right, the junior creditor can capture a value that equals his own estimate of the value of his entitlement. If other parties are more optimistic and have higher estimates of V, however, the creditor will be able to capture a value that exceeds his own estimate of his entitlement. In such a case, the market price of his type-*B* right will exceed its \$0.50 value to him, and he will sell his right for this higher market price.

Finally, if the junior creditor believes that V exceeds \$2, then the value of his entitlement based on his estimate of V will be \$1 (a payment in full of his claim) (see Table 2). If others also believe that V exceeds \$2, then, because type-C rights will be exercised, type-B rights will be redeemed at \$1 (and will trade at \$1 beforehand). In such a case, the creditor will end up with a value that equals in his eyes the value of his entitlement. But if others are more pessimistic and believe that V is below \$2, then the participant's type-B right will not be redeemed, and by exercising it, he will end up with a value exceeding in his eyes the value of his entitlement.

E. Note on Participants' Information and Financial Resources

A question that some may raise is whether one can object to the proposed method by arguing that participants lack sufficient information or financial resources.

1. Information. — Under the proposed method, as well as under the existing process of division, participants must make decisions on the basis of whatever information they have concerning the reorganized company's value. Therefore, it is necessary to examine whether, in comparison to the existing process, the proposed method might either increase the amount of information that participants need or decrease the amount of information that they possess.

The proposed method does not increase the participants' need for information. Under the existing process, each class of participants must make its bargaining and litigation decisions on the basis of whatever estimate of the reorganized company's value it happens to have. Assuming that participants will not have less information under the proposed method than under the existing process, they will be able to use the same estimate to make the necessary decisions about their rights.

Indeed, under the proposed method, participants will not even need to make a judgment, as they must under the existing process, concerning their best estimate of the reorganized company's value. They will only have to make the much more limited judgment whether the reorganized company's value exceeds the estimate that is implicit in the market price of their rights (that is, whether the value of their rights exceeds the rights' market price).

Finally, there is no reason to assume that participants will have less information under the proposed method than under the existing process. Indeed, the proposed method provides an important additional source of information — the market pricing of rights. To be sure, the proposed method may still reduce the amount of information that participants will have if it substantially decreases the extent to which participants take advantage of the available sources of information. Such a decrease may arguably take place because of collective

action problems: under the proposed method, participants will act individually rather than collectively, and they may have less incentive or ability to look for information. But the proposed method will not prevent participants from acquiring information as a class rather than individually when there are some advantages in doing so: in such cases, the committee representing the class will likely engage in information acquisition (say, by hiring an investment banker to do the job) and then disseminate its conclusions to individual class members.

2. *Financial Resources and Willingness to Invest.* — Another possible objection to the method arises from the fact that the method will require some participants to invest in the enterprise to capture the value to which they are entitled. Participants in an insolvent company, so the argument might go, may reasonably be reluctant to make such an investment or may lack the necessary financial resources.

It should initially be noted that most participants will not need to put in any money to capture the value of their entitlements. For one thing, many participants will have their rights redeemed by the company. Furthermore, even participants whose rights are not redeemed by the company will not have to put in any money if they believe that the market does not underestimate the reorganized company's value; in such a case, they can capture the value to which they believe they are entitled by selling their rights on the market. Thus, a given participant will need to invest money to capture the value of his entitlement only when the company does not redeem his rights and he believes that the market is underestimating the reorganized company's value.

Consider a junior creditor in our example who believes that V is \$1.50 (in other words, that buying an *RC* unit at \$1.50 will provide an "adequate" rate of return) — and who thus believes that he is entitled to \$0.50. Suppose also that the market estimates V to be only \$1.30 and thus prices the creditor's type-*B* right at \$0.30. The creditor will be able to capture the value to which he believes he is entitled only if he invests the \$1 necessary to exercise his right.

Let us first suppose that the amount at stake constitutes a small fraction of the creditor's wealth. In such a case, the creditor's need to put in \$1 will not provide him with a basis for complaint, for if V is equal to \$1.50 in his judgment, then from his perspective purchasing a unit worth V for \$1 must be equivalent to his getting \$0.50. To see this equivalency, observe that purchasing a unit for \$1 is equivalent to receiving \$0.50 plus being required to purchase an *RC* unit for \$1.50. Given that the amount at stake is small relative to the creditor's wealth and that the creditor values the *RC* unit at \$1.50, the creditor should be indifferent to the requirement that he purchase a unit for \$1.50.

Thus, if the amounts that participants need to invest to exercise their rights are small relative to their wealth, which I suspect is the case for most participants in reorganizations of publicly traded corporations, then the need to invest will pose no problem. If participants' wealth is not sufficiently large relative to the amount at stake, however, problems may arise. Suppose, for instance, that the junior creditor in the example discussed above does not have the $1 necessary to exercise his right. In such a situation, the creditor may complain that his lack of funds forces him to sell his type-*B* right for a price below the value of his entitlements: given the undervaluation of *RC*'s units by the market, he will end up with only $0.30 rather than the $0.50 to which he believes he is entitled.

Even when such a liquidity problem does arise, it commonly can be eliminated or at least substantially alleviated by the participant's ability to borrow. In a well-functioning capital market, the junior creditor's borrowing power will be augmented by his ability to use as collateral the very *RC* unit that he will buy. In the example under consideration, if the market estimates the value of an *RC* unit at $1.30, then a junior creditor will be able to borrow the $1 necessary to exercise his option by pledging the purchased *RC* unit as a collateral.[40]

In sum, although the need to invest funds might pose some problems to the effectiveness of the proposed method, these problems appear to be quite limited. Most participants will not need to invest any amount in order to capture the value to which they believe they are entitled, because their rights will be either redeemed or valued sufficiently by the market. Furthermore, those who will need to invest will have no basis for complaining as long as the amount at stake is small relative to their wealth. Finally, as for those whose rights will be neither redeemed nor sufficiently valued by the market and whose wealth is not sufficiently large relative to the amount at stake, any problem resulting from the need to invest will be mitigated by their ability to borrow.

V. IMPLEMENTATION

A. *Under a New Reorganization Regime*

The proposed method of division is put forward as the basis for reform of reorganization law. The optimal reorganization regime, I

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40 Lack of sufficient financial resources, then, may pose a problem only if the market's estimate of *V* is lower than not only the creditor's estimate but also the $1 that the creditor needs to exercise his right. For example, if the market estimates *V* at $0.80, then the junior creditor will not be able to borrow the full $1 necessary to exercise his right by pledging the unit as collateral.

suggest, is one that requires and facilitates the use of this method in every case of reorganization.

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

Although the process of division will largely follow automatically from the method's principles, a reorganization plan will be necessary to fix some limited elements of the reorganized company's features. In particular, the plan would fix the reorganized company's capital structure.[41] Several possible parties can be charged with designing a reorganization plan for confirmation by the supervising court. Possible candidates include a trustee appointed by the court, incumbent management (which presumably represents the equityholders), or the committee representing a certain class of creditors. Note that assigning the role of designing the plan to representatives of a given class of participants will not create a conflict-of-interest problem. Given the way in which the proposed method operates, the choice of capital structure cannot be used to divert value from one class of participants to another. Therefore, in choosing the capital structure, the party charged with designing the reorganization plan will aim solely at maximizing the value of the reorganized company.

Because of the limited elements that the reorganization plan will cover, designing it and receiving the court's confirmation will presumably take relatively little time. Once the capital structure is specified, the division will proceed automatically and swiftly: rights to the reorganized company's securities will be distributed to participants in accordance with the method, the securities themselves will be distributed shortly afterwards as the rights are exercised, and the company will be out of the reorganization process, hopefully on its way to a bright future.

This regime will best address the efficiency and fairness problems that have thus far afflicted the division process in corporate reorganizations. First, the outcome will always be in accordance with the entitlements of all the participants involved. Second, the choice of capital structure will be value maximizing. Third, the delay and litigation costs under the new regime will be the smallest possible under any reorganization regime (largely consisting of the unavoidable delay and costs involved in determining the size and ranking of claims).

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[41] As Part VI will explain, the plan may also include a few other elements, such as the treatment of secured claims and the reinstatement of some contracts with favorable terms.

B. Under Existing Law

The proposed method may be useful even under the existing reorganization rules. Some parties should find it in their interest to use the method as a basis for the reorganization plans that they file.

Under the existing rules, the equityholders usually have the exclusive right for a specified period of time to file (and seek confirmation of) a reorganization plan.[42] Subsequently, any participant may file a reorganization plan.[43] To obtain confirmation of a reorganization plan, its proponents must achieve either (i) acceptance of the plan by every class, or (ii) if a class objects, a judicial overruling of this objection on the grounds that the plan provides the class with no less than its entitlement.[44] Achieving either (i) or (ii) is often problematic or at least time-consuming: securing class approval involves the complications of bargaining; and obtaining a judicial determination that the plan provides the class with the value of its entitlement involves the difficult problems of valuation.

Once the period in which the equityholders have exclusive right to propose plans has passed, it will be in the interest of the senior creditors to file a plan based on the proposed method. The proposed method will provide the senior creditors either with the full value of their claims or at least with all of the reorganized company's securities, which is all they can hope for. Furthermore, they will be able to secure confirmation of such a plan relatively quickly; given the way in which the method is designed, they should face no difficulty in demonstrating to the court that their plan provides all other classes with no less than the value to which these classes are entitled.

Using the method will free the senior creditors from the threat of strategic behavior by participants junior to them. At present, juniors may seek more than the value to which they are entitled by threatening to oppose the plan and create protracted litigation. The proposed method will eliminate this threat by enabling the senior creditors to demonstrate easily that their plan provides all participants with a value consistent with their entitlements.

If parties do use the proposed method in their confirmation plans, some of the potential benefits of the method will be obtained even under existing rules. First, and most importantly, outcomes will come closer to those suggested by the participants' entitlements. Second, parties using the method as a basis for their reorganization plans will choose a capital structure solely on the basis of their judgment as to which structure would be value maximizing. Third, delays and litigation costs will decrease significantly.

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42 *See* 11 U.S.C. § 1121(b) (1982); Trost, *supra* note 13, at 1325–26.

43 *See* 11 U.S.C. § 1121(c) (1982 & Supp. IV 1986).

44 *See id.* § 1129(a)(7)(A), (b)(1); Trost, *supra* note 13, at 1328–44.

VI. Extensions

The analysis in Parts III and IV used a concrete example for convenience of illustration. This Part drops the simplifying assumptions used in constructing that example and considers four important complications that are present in reorganizations. I first show how the method can be adjusted easily to apply to situations in which there are more than three classes. I then discuss three issues that may arise and require treatment under any reorganization regime — contracts with favorable terms that are worth reinstating, secured claims, and concentration of claims in one hand. As I explain, the proposed method of division is consistent with any way that reorganization law might wish to treat these issues. Consequently, the potential presence of these problems does not undermine my earlier conclusion that the proposed method offers the best way of dividing the reorganization pie.

A. More Than Three Classes

The example used above consisted of a company with three consecutively ranked classes, each with 100 units of membership. The method, however, can be applied easily in the general case of a company with any number of consecutively ranked classes, each with any number of membership units. Describing the operation of the method in general terms, applicable to any such case, the rights distributed to participants will be as follows.

Each unit of membership in the most senior class will entitle its holder to receive a right that the company may redeem for the participant's pro rata fraction of the class' total claim. If this right is not redeemed, it will entitle its holder to receive (without any payment) his pro rata fraction of the reorganized company's securities.[45]

Each unit of membership in any intermediate class (any class below the most senior one and above the most junior one) will entitle its holder to a right that may be redeemed by the company for the participant's pro rata fraction of the class' total claim. If the right is not redeemed, it will entitle its holder to purchase his pro rata fraction of the company's securities for a price equal to his pro rata fraction of the total claim of the classes above his class.[46]

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[45] For example, if the total claim of the senior class is $300, then each member of the class will receive, for each $1 debt that he is owed, a right that may be redeemed by the company for $1 and, if not redeemed, will entitle its holder to receive 1/300 of the reorganized company's securities.

[46] Consider, for example, a situation in which the total claim of a given intermediate class of creditors is $200 and the total claim of the classes above it is $540. In this case, any member of this intermediate class will receive, for each $1 debt that he is owed, a right that may be redeemed by the company for $1 and, if not redeemed, will entitle him to purchase 1/200 of the company's securities for a price equal to $2.70 (1/200 of the total preceding claims of $540).

Finally, each unit of membership in the class of residual claimants (the most junior class) will entitle its holder to receive a right that may not be redeemed by the company. This right will entitle its holder to purchase his pro rata fraction of the company's securities for a price equal to his pro rata fraction of the total claim of all the classes above the residual claimants' class.[47]

B. Contracts with Favorable Terms

Prior to entering the reorganization stage, a company presumably has a whole set of outstanding contracts. To the extent that such contracts are breached or discontinued by the reorganization process or by preceding events, the other parties to the contracts are likely to have claims against the company. Some of the contracts, however, may be at terms that appear favorable to the company, given the information available at the reorganization stage. The breach or discontinuation of these contracts will not be in the interest of any participants except the parties with whom the company has the contracts; the pie available to the other participants will be maximized by "reinstating" these contracts, that is, by having the reorganized company maintain them.

A typical case of a contract that is worth reinstating is one providing the company with a long term loan at an interest rate that at the time of reorganization appears favorable to the company. Consider a company that took from a bank a $100,000 long term loan with an interest rate of 5% and suppose that by the time of the reorganization interest rates have risen to 10%. In this case, the bank may wish to have the loan declared in default and consequently get a claim of $100,000 against the reorganizing company. But the pie available to the other participants may well be maximized by reinstating the loan contract, because, given the contract's 5% interest rate, the present value of the future installments on the loan will be much less than $100,000.

Any reorganization regime must determine whether and under what conditions reinstatement of contracts is allowed.[48] Existing reorganization law, for example, includes a detailed arrangement concerning the possibility of reinstating some contracts; participants whose contracts with the company are reinstated do not need to

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[47] For example, suppose that the total claim of the classes preceding the residual claimants' class is $1800 and that the residual claimants' class includes 200 units. Then, each unit in this class will entitle the holder to a right to purchase 1/200 of the reorganized company's securities for $9 ($1800/200).

[48] For a discussion of some of the policy issues that are involved in this determination, see T. JACKSON, cited in note 7 above, at 35–44.

approve the reorganization plan because their claims are "unimpaired."[49]

Whichever approach we wish reorganization law to take to the issue of reinstating contracts, the operation of the proposed method of division will be consistent with that approach. Given the regime's rules concerning which contracts can be reinstated, the reorganization plan filed under the proposed method will specify those contracts that the plan's designers elected to reinstate (as well as the means of reinstating them). For the reasons noted earlier,[50] the designers of the plan presumably will choose to reinstate only those contracts whose reinstatement will maximize the pie available to the rest of the participants. The parties to the reinstated contracts will have claims that are not impaired and they therefore will not participate in the division of rights. The reorganized company, however, will be subject to the reinstated contracts, and the value of its securities will be affected by this fact. The division of rights among the participants whose claims are impaired will then proceed smoothly according to the proposed method.

C. Secured Claims

Thus far the analysis has assumed that the priority of a given claim over other claims necessarily applies to all assets of the debtor company. Some claims, however, are secured claims, which means that their priority over other claims is with respect only to a specific subset of the debtor's assets. Secured claims are often present in reorganizations.

In the presence of secured claims, any reorganization regime (and indeed any liquidation regime as well) must resolve two issues. First, the regime must choose both a method for deciding whether a claim secured by a given asset is *fully* secured (a method that may include estimating the asset's value) and, for claims that are not fully secured, a method for dividing these claims into fully secured and unsecured parts. Second, the regime must determine whether the holder of a secured claim has an *in rem* right to have the asset sold to pay his claim or only a right to be paid the appraised value of the asset. The existing reorganization regime includes an arrangement governing these issues,[51] and commentators have been debating the merits of this arrangement as well as possible reforms.[52]

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[49] *See* 11 U.S.C. §§ 1124, 1126(f) (1982 & Supp. IV 1986).

[50] *See supra* p. 798.

[51] *See* 11 U.S.C. §§ 506, 1111(b) (1982 & Supp. IV 1986).

[52] *See, e.g.*, Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984); Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VANDERBILT L. REV. 931 (1985).

Whichever arrangement we wish to apply to secured claims, the proposed method of division will be consistent with it. The arrangement will govern the identification of fully secured claims and their treatment under the reorganization plan.[53] The units of the reorganized company's securities that will then be available for distribution will be divided among the holders of unsecured claims and interests according to the proposed method of division.

D. Concentration of Claims in One Hand

The last complication to be discussed, which appears less frequently than those discussed above, is the possibility of a concentration of claims in one hand. Suppose, for instance, that 60% of the units in Class *A* in our simple example (the class of senior creditors) are held by a given bank. In such a case, if the type-*A* rights are not redeemed by the company, the bank will get 60% of the company's securities while the other members of the class will get 40% of these securities. The rights given to the bank will be worth more per right than those given to the other senior creditors, because shares in a controlling block are worth more than minority shares. Consequently, the value given to the senior class will be divided disproportionately, with the bank getting more than the value of its entitlement and the other members of the class getting less than the value of their entitlements.

Such a problem can arise, however, in any reorganization regime that divides the reorganized company's securities among the participants.[54] As long as the division proceeds under the assumption that any two shares of the reorganized company are worth the same amount, a concentration of claims may lead to a given participant's receiving a controlling block; as a result, this participant will end up with more than the value of his entitlement, whereas others will receive less than the value of theirs. Because this problem may arise and require a solution under any reorganization regime, its potential presence does not weaken my earlier conclusion that the proposed method is the best way of dividing the reorganization pie.

Although the problem of concentrated claims is unlikely to arise frequently and is in no way unique to the proposed method, I do wish to note what appears to be the best means of addressing it.[55] If the

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[53] If the arrangement requires or suggests making some immediate payments to the holders of the secured claims, then the reorganization plan may include provisions for selling assets or raising funds in some other way. For the reasons noted earlier, *see supra* p. 798, the designers of the plan presumably will seek to adopt that allowable method of treating secured claims that will maximize the pie available to the rest of the participants.

[54] Thus, for example, Roe, in discussing his proposed reorganization regime, recognized the existence of this problem. *See* Roe, *supra* note 8, at 575–76.

[55] The endorsed approach is that suggested by Roe, cited in note 8, at 575–76.

exercise of rights provides someone with a controlling block of the reorganized company's equity, then the holder of this controlling block should be required to dispose of his controlling position — by selling enough shares to go below a specified control threshold — within a specified period of time. Under such a rule, those who exercise rights will be able to count on receiving shares that, at least after a specified period of time, will not be minority shares.

VII. CONCLUSION

This Article has put forward a new method of division for corporate reorganizations. This method can eliminate certain efficiency and fairness problems that have been long viewed as inherent to the reorganization process. Under the method, once the size and relative priority of the participants' claims are determined, the division of the reorganization pie will be resolved quickly and efficiently — and in perfect consistency with the entitlements of all the participants. The method is put forward as a basis for law reform: the optimal reorganization regime is one that requires and facilitates the application of the proposed method in every reorganization case. Furthermore, the method can be used even under the existing legal rules, as a basis for reorganization plans that participants may want to file. It is hoped that the method will indeed prove useful to public officials overseeing corporate reorganizations and to participants in such reorganizations.