AMERICAN BANKRUPTCY INSTITUTE FIELD HEARING

Philadelphia, Pennsylvania
7 November 2013

<u>Statement of Anthony J. Casey</u>

I thank the Commission for inviting me to appear at this hearing and for the opportunity to provide my thoughts on reforming Chapter 11. I am an assistant professor at The University of Chicago Law School. Prior to entering academics I practiced law for seven years as a litigation attorney – first at Wachtell, Lipton, Rosen & Katz and then at Kirkland & Ellis, LLP (Chicago office). A majority of my time in practice was spent in litigating disputes arising from large corporate mergers and disputes arising in Chapter 11 cases.

My academic research and writing focus on corporate reorganization and restructuring both in and out of bankruptcy. My published scholarship has specifically focused on the impact that bankruptcy priority rules have on financial markets and the governance of business firms.[1]

In these comments, I focus on the question of priority rules in Chapter 11 and try to identify key issues that warrant the Commission's attention. I will keep my initial comments at a general level, but I am happy to discuss in more detail.

As the Commission is aware, the current rule in bankruptcy is that a plan must adhere to "absolute priority." Though those words do not appear in the Bankruptcy Code, the language of 11 U.S.C. §1129 plainly incorporates the rule through the use of words that have long been interpreted to require the absolute priority rule.[2] The history that led to the entrenchment of the absolute priority rule is a complicated maze that has been analyzed extensively by other experts in this area.[3] For the purposes here, it is enough to

[1] *See, for example,* Anthony J. Casey, *The Creditors' Bargain and Option Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011).

[2] *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106 (1939).

[3] John D. Ayer, *Rethinking Absolute Priority after Ahlers*, 87 MICH. L. REV. 963 (1989); David A. Skeel Jr, *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325 (1998); Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR.

note that there are reasons to question the assumption that the rule was always present in reorganizations.

Because the Commission is considering reforms to the Code, it is more important to focus on the theoretical and practical foundations for the absolute priority rule – both of which are shaky at best.

The theoretical justification for absolute priority is often stated in terms of protecting non-bankruptcy entitlements. Outside of bankruptcy, the argument goes, senior secured creditors[4] must always be paid first and, therefore, in bankruptcy senior secured creditors must always be paid first. This view misses important aspects of the bankruptcy process. There is no doubt that outside of bankruptcy a senior creditor is entitled to receive the value of its claim first. But the difficult question for a priority rule is "what exactly is the nature of that claim?" The answer is not as plain as the absolute priority rule implies.

It is worth pausing to note that the real question is not "priority" per se. Rather, the question is what exactly each class of creditors is entitled to when a firm is reorganized in bankruptcy. This turns more on defining substantive rights that ordering priority. The absolute priority rule has, however, been almost universally viewed to incorporate within it this notion of collapsing all future possibilities to present day value and then paying out claims strictly in order of liquidation priority.[5] That is to say reorganizations are always paid out as if they are liquidations even though the firm continues as a going concern. I follow the convention of referring to this theory as absolute priority.

There is no obvious entitlement outside of bankruptcy for a senior secured creditor to capture going concern value of a firm without keeping the claims of the junior creditors alive. If the firm has a potential upside in the future and the secured creditor wants to

---

L J. 387 (1998); Douglas G. Baird and Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 S. CT. REV. 393.

[4] I discuss the issues in terms senior secured and junior creditors throughout. The same reasoning applies to the priority between all layers of creditors and between creditors and equity equity.

[5] *See, for example*, Walter J. Blum and Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganization*, 41 U. CHI. L. REV. 651, 654 (1974) ("[B]efore a class of investors can participate in a reorganization, all more senior classes must be compensated in full for their claims, measured on the basis of their priorities upon involuntary liquidation.").

capture that upside by allowing the firm to continue (by, for example, waiving default or providing additional financing) the junior creditors maintain their claims. If the upside is achieved, those claims will be paid. This creates a sort of embedded option that the junior creditors have in the future upside value of the firm.

On the other hand, the secured creditor may exercise its foreclosure and liquidation rights when the debtor defaults. But that liquidation cuts off the future of the assets as part of a going concern. Thus, the senior secured creditor's claim on going concern is extinguished along with the junior creditors' claims. The senior secured creditor essentially has two options: take the liquidation value or keep the firm alive subject to the junior creditors' claims.

Thus, the non-bankruptcy entitlements simply require that a senior secured creditor be paid the liquidation value before any junior creditor recovers. The open question is what to do with the going concern value that is created by the Chapter 11 reorganization process. One view is that the junior creditors are entitled to their claim on the future upside value under any scenario where the firm is not liquidated. That view implies that the absolute priority rule is violating non-bankruptcy entitlements of the creditors. Even if this approach is rejected, the best one can say is that the Chapter 11 process is creating going concern value that would not exist outside of bankruptcy and, therefore, non-bankruptcy entitlements are not dispositive on these questions of priority.

The future possibilities of the firm could be collapsed to a snapshot that simply distributes value with no reference to who would have had a claim to that value if the firm had survived outside of bankruptcy. That is the absolute priority rule. Alternatively, all creditors could receive a portion of going concern value that replicates the claims they would have had against the new entity if reorganization were possible outside of bankruptcy. That might be called relative priority or option-preservation priority depending on the specific details. Other potential rules might also be considered.

As the Commission now has before it the responsibility and opportunity of evaluating the potential answers to these questions, I will discuss a few of the practical implications of the potential rules. As professors Morrison and Ayotte (and others) have shown, senior secured creditors exercise substantial control over an asset and often cause it to be sold below true value.[6] This imposes a cost on junior creditors who would benefit

---

[6] Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009).

from a sale at true value. These "fire sales" are made possible in large part because of the dynamics created by the absolute priority rule.

As is often the case in bankruptcy law, one reaction to the problem of fire sales is to allow junior creditors to raise procedural objections. This solution is deeply flawed. When the objections fail, the senior secured creditors maintain control and force a sale at a discount. When the objections succeed, the junior creditors gain control and often keep a failing firm alive too long hoping for a fortuitous turn around.[7] This is the worst of both worlds.

This type of dilemma is pervasive throughout the code, affecting things like hedge fund disclosure, plan confirmation, valuation, and the like. Where a distortion is identified, the suggested cure is court review and procedural protection. This cure often adds additional distortions and imposes further costs on the estate. With this in mind, reform mechanisms, should – as much as possible – avoid relying on new standards that require extensive judicial inquiry and additional process.

Additional costs stemming from absolute priority include the creation of divergent incentives between classes of creditors. These incentives distort the decision to file bankruptcy in the first place. Because the creditors' relative rights are significantly different inside and outside of bankruptcy, there is no party with a cohesive incentive to maximize the estate value when the decision to file or not to file is being made. This will lead to filings that are too early in some cases and too late in others. It will similarly distort the number of filings.

Finally, it is no secret that absolute priority is not strictly followed.[8] Many corporate reorganizations end up with a plan or sale that distributes value in a manner that violates the formal requirements of absolute priority. This is often (but not always) done by settlement, which is less concerning. It is, however, telling that the parties routinely negotiate around a default rule that is supposedly mandatory. This occurs in part because of the problem noted above: the absolute priority rule vests *de facto* control in

---

[7] *Id.*

[8] Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L. J. 1930 (2006); Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 5 J. FIN. 1457 (1990); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285 (1990).

senior creditors and, in response, junior creditors are given procedural protections that create hold-up value. The result is that procedural disputes and objections are resolved through deviations from absolute priority. We see a similar dynamic at play in cases that have been examined as gifting and new value cases.

Turning to the reforms that will address these issues, the Commission should explore the possibility of abandoning the absolute priority rule and replacing it with a system of relative priority. In considering new rules, I suggest three goals. The important characteristics of the system should be: 1) substantive protection of all creditors' claims on the future value of a going concern (subject to senior secured creditors' rights to liquidation value); 2) reduction in reliance on ***procedural*** protections for junior creditors; 3) a mechanism to allow for going concern sales in bankruptcy while reducing the incentives for fire sales.

One potential way to achieve these goals would be to use warrants or options issued to junior creditors. This method of solving valuation disputes is commonly adopted by parties in negotiating a plan that can be agreed upon.[9] The Commission might consider a default rule that imposes a capital structure with options and warrants. In that way, a junior creditor could be awarded call options at the beginning of a case. These options would have a strike price equal to the face value of the next senior class and would be awarded to the class of creditors pro rata.[10] These options would have a very long life. The length might be set by statute or turn on certain factors about the estate.[11]

In a going concern sale, this would require the senior secured creditor to either 1) sell the asset subject to the option; or 2) buy out the options. Of course in the first scenario a

---

[9] Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy,* 119 YALE L.J. 648 (2010); Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV. 403, 445; Eric Nirenberg, *Stock Warrants and Bankruptcy Restructuring Efficiency*, working paper (2005).

[10] For example, if there was one senior creditor with a lien of $100 and two junior creditors, the junior creditors would each have an option to buy 50% of the firm at a price of $50 (for each half).

[11] This distinguishes the options from "Bebchuk options" which would expire immediately. Lucian Arye Bebchuk*, A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 755 (1988). Elsewhere, I have suggested perpetual options. Anthony J. Casey, *The Creditors' Bargain and Option Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011). In the interest of having finite boundaries, an expiration period of significant duration would achieve the same purposes with more certainty and easier administration.

party buying the asset would reduce the offer price by the value of the options. But that is the optimal outcome. The senior creditor thus internalizes the junior creditors' option value in selling the asset. And, if the firm has little chance of increasing in value, the options will have little value. This will mean they are not costly to buyout and they create small hold-up potential. An option that has a negligible chance of ever being in the money imposes a negligible burden on the new equity holders.

The senior secured creditor could also be given the procedural opportunity to avoid the default rule if it can easily prove to the court that the options are worthless and should be retracted. This shifts the burden and the procedural hold up to the secured creditor, which further aligns the appropriate incentives with the appropriate control rights. Likely, the senior secured creditor will only engage this procedural move if 1) it has a high likelihood of success and 2) a low likelihood of costly delay of a sale.

On the other hand, the junior creditors – now having the substantive protection that the option provides – may not need the full extent of procedural protections they are currently afforded.

Conclusion

The Commission's project of reexamining Chapter 11 provides the rare opportunity to give full consideration to the appropriate distribution of value in reorganizations. The absolute priority rule has evolved over the last century into a rule that enjoys an almost revered and unquestionable status with little theoretic or practical justification. In truth the rule is neither obvious nor foundational to any goal of Chapter 11 reorganization. And it appears to introduce avoidable costs and distortions. I am hopeful that my comments will be helpful to the Commission as it reexamines the rule and considers potential alternatives.