Vanderbilt Law Review

Volume 57 | Issue 3 Article 1

4-2004

A Team Production Theory of Bankruptcy Reorganization

Lynn M. LoPucki

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Bankruptcy Law Commons, and the Business Organizations Law Commons

Recommended Citation

Lynn M. LoPucki, A Team Production Theory of Bankruptcy Reorganization, 57 *Vanderbilt Law Review* 741 (2019)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol57/iss3/1

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

VANDERBILT LAW REVIEW

VOLUME 57 APRIL 2004 NUMBER 3

A Team Production Theory of Bankruptcy Reorganization

Lynn M. LoPucki[*]

I. INTRODUCTION ... 742
II. THE CREDITORS' BARGAIN THEORY OF BANKRUPTCY ... 744
III. THE TEAM PRODUCTION THEORY OF CORPORATE LAW ... 749
A. *The Theory* ... 749
B. *Competing Theories* ... 752
IV. THE TEAM PRODUCTION THEORY OF BANKRUPTCY REORGANIZATION ... 754
A. *Incorporation of Bankruptcy Reorganization in the Team Production Contract* ... 755
B. *Reconciling Team Entitlements with Bankruptcy Entitlements* ... 757
1. Cramdown ... 759
2. Best Interests ... 762
C. *Reorganization for Whose Benefit?* ... 763
V. COMPARING THE CREDITORS' BARGAIN AND TEAM PRODUCTION THEORIES ... 765
A. *Whose Interests Should Bankruptcy Serve?* ... 765
1. Comparison as Positive Theory ... 768
2. Comparison as Normative Theory ... 769

[*] Security Pacific Bank Professor of Law, UCLA Law School. lopucki@law.ucla.edu. I thank Frances Foster, Bruce Johnson, Scott Keiff, John Pottow, Lynn Stout, Eric Talley, and participants in workshops at the American Law and Economics Association 2003 Annual Meeting, George Mason University School of Law, USC School of Law, and Washington University School of Law for comments on earlier drafts.

B. *The Debtor-In-Possession* 770
C. *Protecting Board Independence* 772
D. *Plan Negotiations* 773
E. *Is Reorganization Efficient?* 776
VI. CONCLUSIONS 778

[S]ociety must insist on the maintenance of the "going concern" and must if necessary sacrifice to it the individual rights of shareholders, creditors, workers, and, in the last analysis, even of consumers.

– Peter Drucker[1]

I. INTRODUCTION

In the year before United Airlines filed for bankruptcy reorganization, the firm lost $3.2 billion.[2] Fierce competition in the airline industry prevents United from stemming its losses solely through increases in revenues. Costs will have to be cut. The necessary expense reductions could come from reductions in employee pay and benefits, reductions in the amounts owing to creditors (which reduce interest expense), or both. Which should it be?

United's situation is complicated by the fact that its employees own 55 percent of its stock and that their wage levels are protected by a collective bargaining agreement.[3] But if we assume those protections away, we reach a fundamental issue that has divided bankruptcy scholars for two decades: whose interests should bankruptcy reorganization serve?

The currently prevailing contractarian theories of the firm and of bankruptcy recommend cutting labor costs first. Bankruptcy, these theorists postulate, exists solely for the benefit of the creditors and shareholders of the firm. The theorists recognize that the interests of employees, suppliers, customers, and communities should be taken into account to the extent particular members of those constituencies are creditors with enforceable legal rights against assets under nonbankruptcy law. But they assert that to take any other interest of

1. PETER F. DRUCKER, CONCEPT OF THE CORPORATION 21 (rev. ed. 1972).

2. UAL CORPORATION, 10-K REPORT item 6 (2002) (showing (3,212) as the "Net earnings (loss)" for the year ended December 31, 2002, stated in millions), http://www.sec.gov/Archives/edgar/data/100517/000010051703000007/ual.htm.

3. *Id.* item 1 (listing collective bargaining agreements and expiration dates).

those constituencies into account would—as one writer put it—constitute "prima facie theft."[4]

The theorists' first premise derives from the agency theory of the firm. Shareholders own the firm. The board of directors, the managers, and the employees are the shareholders' agents, mere hired hands. When the firm is insolvent, ownership shifts to the creditors. In bankruptcy reorganization, the owners' interests, and theirs alone, are to be served. Debt, it follows, should be cut only as a last resort—after any possible cuts in labor costs.

Another group of bankruptcy scholars, sometimes referred to as "traditionalists," are of the less elegant view that bankruptcy exists to serve a variety of policies and therefore a variety of interests. Their answer to the hypothetical is that the losses should be shared among all interested parties, including creditors and shareholders. Because their arguments are noncontractarian and do not place economic efficiency first, they fall on deaf contractarian ears. The two groups talk past one another.[5]

In 1999, Professors Margaret Blair and Lynn Stout introduced a new and powerful contractarian theory of the public corporation—one that only now is beginning to have its impact.[6] In this Team Production Theory of the firm, shareholders and creditors are no longer primary. They are merely two members of the production team.[7]

The Team Production Theory has striking implications for bankruptcy theory. Applied to bankruptcy reorganization, the Team Production Theory turns existing contractarian bankruptcy theory virtually upside down. Bankruptcy reorganization ceases to be a regulation imposed by government and instead becomes a contract term by which creditors and shareholders agree to subordinate their legal rights to the preservation of the going concern. That preservation may require that the firm honor team production obligations by giving them priority over "legal"[8] obligations. In the case of United, for

---

4. Charles W. Mooney, Jr., A Normative Theory of Bankruptcy Law: Bankruptcy Law As (Is) Civil Procedure (2004) (unpublished manuscript, on file with author) ("But however the approach may be disguised in noble rhetoric, service to these extraneous interests at the expense of or risk to rightsholders is *prima facie* theft.").

5. Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 575 (1998) (acknowledging that two groups of bankruptcy scholars exist and that "few in either group pay much attention to the other").

6. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

7. *Id.*

8. "Legal" appears in quotation marks because these contractual obligations to creditors and shareholders are no more legally binding than the rights of other team members to

example, it may require that the firm reward employees for past or future contributions by continuing to pay above-market wages and pass the costs on to creditors by reducing the amounts owing to them.

The Team Production Theory of Bankruptcy Reorganization, like the Creditors' Bargain Theory it challenges, is contractarian. It attempts to identify economically efficient institutions by assuming they are the institutions contracting parties would choose. In contrast to the Creditors' Bargain Theory, which is based on a hypothetical contract derived by the theorist, the Team Production Theory is based on the actual contracts entered into by team members. Researchers can test the Team Production Theory empirically by determining whether the actual contracts match those asserted by the Team Production theorist. The theory is both positive in attempting to describe the actual contracts among the team members and normative in its assertion that the actual contracts should be enforced because they are efficient.

Part II of this article describes and critiques the currently prevailing contractarian theory of bankruptcy, the Creditors' Bargain Theory. Part III lays out the Team Production Theory of Corporate Law and briefly notes its points of departure from prior theory. Part IV presents the Team Production Theory of Bankruptcy Reorganization and explains its application. Part V explores the Team Production Theory's implications for bankruptcy system operation by comparing them to Creditors' Bargain Theory's implications. The comparison shows Team Production Theory implications to be more congruent with bankruptcy system operation than are Creditors' Bargain Theory implications. Part VI concludes that Team Production Theory should be taken seriously because it so accurately describes bankruptcy system operation. Ultimately, however, the Team Production Theory will stand or fall on the basis of empirical evidence.

II. THE CREDITORS' BARGAIN THEORY OF BANKRUPTCY

Professor Thomas H. Jackson proposed the Creditors' Bargain Theory of bankruptcy in an article published in 1982.[9] Jackson proposed to "view bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an ex ante

---

governance by a board of directors. All parties agreed that the board could alter the rights of creditors and shareholders through bankruptcy. *See infra* Part III.A.

9. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 860 (1982).

position."[10] That is, Jackson assumed that the essential features of the bankruptcy system were imposed on creditors; creditors did not choose them. He proposed to calculate what features the creditors would have chosen had they been free to choose. He assumed that the terms of their hypothetical bargain would be efficient because those terms would be the product of unfettered bargaining among property owners. Once derived, those terms would stand as a critique of the corresponding provisions of bankruptcy law. Thus, Jackson's theory—like Team Production—fell within the larger class of theories referred to as "contractarian."

Jackson developed the theory in a series of articles coauthored with Professor Douglas Baird,[11] an article coauthored with Professor Robert Scott,[12] and a book.[13] Two key moves defined the Creditors' Bargain Theory and drove the results. The first move was to consider only entitlements created under nonbankruptcy law as legitimate. That is, in calculating the hypothetical bargain that would define the ideal bankruptcy system, Creditors' Bargain theorists assumed that the parties bargained solely from the entitlements created under nonbankruptcy law, and did not bargain from any entitlements created under bankruptcy laws. Jackson did not argue for this position, but simply adopted it as a first premise: "[I]n its role as a collective debt-collection device, bankruptcy law should not create rights. Instead, it should act to ensure that the rights that exist are vindicated to the extent possible."[14] In a later article, Baird joined in making the same point. "Bankruptcy law should change a substantive nonbankruptcy entitlement rule only when doing so preserves the value of assets for the group of investors holding rights in them."[15] Bankruptcy entitlements were dismissed as attempts to redistribute wealth.[16] The effect was to adopt and legitimize the particular set of

10. *Id.*

11. *E.g.*, Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

12. Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989).

13. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

14. JACKSON, *supra* note 13, at 22.

15. Douglas G. Baird & Thomas H. 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, 100 (1984).

16. *See, e.g.*, Jackson & Scott, *supra* note 12, at 160 ("A central premise underlying this creditors' bargain conceptualization is that a system of state law entitlements (including priorities among secured and unsecured creditors) is already in place and that parties know what their priority positions will be so long as state law continues to govern their rights."); *id.* at 161 ("The participants in the bankruptcy bargain could thus be expected to honor this relationship by maintaining the secured creditors' nonbankruptcy entitlements and by preventing redistribution

creditor entitlements that had existed in the nineteenth century, before enactment of the first permanent bankruptcy legislation.

Bankruptcy entitlements developed as a response to the harshness of the rules determining nonbankruptcy entitlements.[17] They included priorities for employees,[18] taxing authorities,[19] consumers who made deposits against future purchases,[20] and others. They also included expansions of the entitlements of subordinate creditors and shareholders, at the expense of secured creditors. Secured creditors lost not only their power to liquidate defaulting debtors but also some of their rights to accrue interest during the bankruptcy case.[21]

Congress and the courts created bankruptcy entitlements with full knowledge of nonbankruptcy entitlements and with the intention of modernizing them.[22] Not surprisingly, once Congress acted to cure the system's deficiencies through changes in bankruptcy law, the evolution of nonbankruptcy law and entitlements slowed. No further evolution was needed.[23] The problems had already been dealt with in

---

in bankruptcy from secured creditors to unsecured creditors and the debtor."); *id.* at 155-56 ("The cornerstone of the creditors' bargain is the normative claim that prebankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group and never to accomplish purely distributional goals.").

17. *E.g.*, WILLIAM D. WARREN & DANIEL J. BUSSEL, BANKRUPTCY 20 (6th ed. 2002) ("Outside of bankruptcy, there is often little relief for a debtor who is unable to pay creditors.").

18. 11 U.S.C. § 507(a)(3)-(4) (2000).

19. 11 U.S.C. § 507(a)(8).

20. 11 U.S.C. § 507(a)(6).

21. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988). Jackson opposed this development by filing amicus briefs in both the Supreme Court and the Ninth Circuit case *Crocker National Bank v. American Mariner Industries, Inc. Id.* at 367; Crocker Nat'l Bank v. Am. Mariner Indus., Inc., 734 F.2d 426, 427 (9th Cir. 1984).

22. *E.g.*, Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U.L. REV. 337, 391 (1993) ("[T]he sales procedures of the federal bankruptcy system are generally perceived as 'vastly superior to those employed in the state remedies subsystem.' "); Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 1005 (1995) ("[T]he bankruptcy system replaces the rigid and unproductive procedures that characterize state execution sales with a flexible process that allows the trustee to proceed in a the manner most likely to produce the greatest net recovery.").

23. For example, once Congress provided debtors with the right to de-accelerate mortgage loans through bankruptcy, state legislatures had no reason to address the problem under state law. *See, e.g.*, LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 239 (4th ed. 2003) ("To look at acceleration and cure only under state law, however, gives a false impression. The see the relationship between default, acceleration and cure requires consideration of state and bankruptcy law together. Most of the creditor's rights are found in state law; most of the debtor's rights are found in bankruptcy law. The two sets of laws combine to create a system in which the debtor who has the ability to cure a default and make the installment payments generally will have the opportunity to do so."); Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 314-51 (arguing that the bankruptcy system performs the same functions as the state

bankruptcy law. Persons significantly disadvantaged under nonbankruptcy law, policymakers apparently concluded, could solve their problems by forcing matters into bankruptcy.

To illustrate, under nonbankruptcy law employees have no priority over other unsecured creditors for unpaid wages and benefits Under bankruptcy law, however, employees have priority for up to $4,650 over other unsecured creditors for wages and benefits.[24] Unpaid employees' lack of priority under nonbankruptcy law does not harm them because they can usually petition the debtor into involuntary bankruptcy, and receive their bankruptcy priority.[25]

Once nonbankruptcy lawyers became comfortable with the bankruptcy system in the 1980s, even business reorganizations outside bankruptcy were effectuated with bankruptcy entitlements in mind. Bankruptcy and nonbankruptcy entitlements functioned as part of a single system, so reform proposals took the cumulative effect of both into account.[26] The Creditors' Bargain Theory sought to destroy that harmony by accepting the entitlements that happened to be lodged in nonbankruptcy law while rejecting those lodged in bankruptcy law. Creditors' Bargain theorists took as their first principle that entitlements in bankruptcy should not differ from entitlements in the absence of bankruptcy.[27]

The Creditors' Bargain theorists were eventually forced to modify that first principle by acknowledging that the bankruptcy rule might sometimes be better.[28] By the time that concession occurred, however, the Creditors' Bargain Theory was so well established that no one noticed that the concession left the Creditors' Bargain Theory with no foundation. The theory originated as a critique of bankruptcy law based on nonbankruptcy entitlements. If bankruptcy law was of

---

remedies system, but performs them hetter); *id.* at 351 (concluding that "in dealing with the debtor in financial difficulty the bankruptcy subsystem performs the functions of the state remedies/bankruptcy system better than the state remedies subsystem in nearly every respect.").

24. 11 U.S.C. § 507(a)(3), (4) (2002).

25. *See* LYNN M. LOPUCKI & CHRISTOPHER R. MIRICK, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS § 2.08 (4th ed. 2003) (discussing this strategy for "preserving wage and benefit priorities").

26. LoPucki, *supra* note 23, at 311 (proposing reform based on combined analysis of the two systems).

27. *See supra* note 12 and accompanying text.

28. Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren,* 54 U. CHI. L. REV. 815, 822 (1987) ("Whenever we must have a legal rule to distribute losses in bankruptcy, we must also have a legal rule that distributes the same loss outside of bankruptcy. All Jackson and I advocate is that these two rules be the same."); *id.* at 823 ("The only point Jackson and I make is that the priorities that exist under nonbankruptcy law should run parallel to priorities in bankruptcy. To the extent that these priorities generate bad distributional consequences, they should be changed in both settings.").

equal dignity with nonbankruptcy law, the theory became a two-edged sword. It could as easily be used to impeach nonbankruptcy entitlements on the basis that they differed from bankruptcy entitlements as for its original purpose of impeaching bankruptcy entitlements on the basis that they differed from nonbankruptcy entitlements. Because it provided no basis to determine which direction the inference should go, the theory was useless.

Creditors' Bargain theorists' second defining move was to regard the corporation as merely a "pool of assets" rather than as a relationship among people and assets. Because the corporation was merely a pool of assets, Jackson reasoned, only those with legal rights in assets were entitled to the benefits of bankruptcy reorganization:

> Under much modern corporate law it is most useful to view shareholders, unsecured creditors, and secured creditors as the owners of the firm. They have different packages of rights to the assets at different times, but they all have the right to call on the firm's assets under one set of circumstances or another. . . . Once one identifies those with rights against the assets, one has identified the pool of owners.[29]

Jackson concluded that others "have no rights that need to be accounted for in a collective proceeding."[30] This narrow view of the interests bankruptcy should protect excludes the interests of managers, workers, suppliers, customers, taxing authorities, and other members of the production team.[31]

Given that the large majority of reorganizing firms are insolvent, the Creditors' Bargain was essentially a bargain that in the event of bankruptcy, the creditors would get everything. The firm

---

29. JACKSON, *supra* note 13, at 32-33.

30. *Id.* at 33.

31. Both Baird and Jackson wrestled with the issue of whether workers should be included in the Creditors' Bargain theory. Each concluded they should not. Jackson stated:

> Workers may have an entitlement to a certain wage level, but as nonbankruptcy law is currently set up, tbey have no draw *as workers* on the assets. They have no say as to whether the assets should remain doing what they are doing or not. They may have claims on the assets to secure their wages or the future terms of their collective bargaining agreement, but to the extent that they do, they are creditors, and it is better to think of them as creditors than as workers. Managers, moreover, may have a good deal of day-to-day control and the leverage that comes from controlling the operating machinery, but they have no *legal* rights to use the assets (other than the assets represented by their own services) in opposition to the wishes of the sbareholders and creditors. Thus, they have no rights that need to be accounted for in a collective proceeding . . . .

Id. at 32-33. Baird recognized that employees and managers could "in some sense" be considered owners. Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 130 (1986) ("This [Creditors' Bargain] view of ownership could be expanded even further. For example, a contributor of labor to a firm may in some sense be seen as an "owner."). But he continued to regard them as nonowners, who would be included in actual bargaining but not in the hypothetical bargain by which he evaluated bankruptcy law. *E.g.*, *id.* at 140 ("In both liquidations and reorganizations, the owners must bargain with the existing managers . . . . ").

should continue to operate only if continued operation was in the interests of the creditors. If the firm did continue to operate, the firm should do so in the manner that maximized benefit to the creditors, even if the effect was to inflict losses on noncreditors. Any consideration of noncreditor interests, the Creditors' Bargain Theory held, would be inefficient.

The Team Production Theory of Bankruptcy Reorganization reaches the conclusion opposite Jackson's. All who made firm-specific investments have rights that need to be accounted for in a collective proceeding. But to understand that theory, one must first understand the Team Production Theory of Corporate Law upon which it is based.

III. THE TEAM PRODUCTION THEORY OF CORPORATE LAW

A. The Theory

Team Production Theory derives its name from the team production concept in the institutional economics literature.[32] The theory is an empirically testable hypothesis regarding the actual bargain among the constituent groups that compose the public corporation.

The hypothesis is that the constituent groups—the "team"—deliberately delegate to the corporation's board of directors ultimate authority over both the direction of the enterprise and the distribution among team members of production rents and surpluses. The team members include all who make firm-specific investments but are unable to protect those investments by direct contracting, personal trust, or reputation.[33] Team members may include stockholders, creditors, executives, other employees, suppliers, customers, local governments, regulatory agencies, and others.[34] Team members intend that they all share in the production rents and surpluses, but are unable to contract directly for that result. Blair and Stout explain the dilemma this way:

---

32. *E.g.*, Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization,* 62 AM. ECON. REV. 777, 779-81 (1972) (discussing "team production").

33. Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board,* 79 WASH. U. L.Q. 403, 416 (2001) (referring to "any group that makes itself vulnerable by making investments specific to the corporation that are not completely protected by an enforceable contract").

34. Blair & Stout, *supra* note 6, at 253 (listing team members); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy,* 75 S. CAL. L. REV. 1189, 1195-96 (2002) (discussing various team members).

> Particularly when production is ongoing, when inputs are difficult to monitor, when the future is uncertain—in other words, in the everyday business environment—explicit contracts that accurately dole out the benefits of production according to contribution and merit are difficult or impossible to draft. Suppose team members agree ex ante to a sharing rule (for example, "divide all gains from team production equally"). Such a rule creates incentives for individual team members to shirk because each member will enjoy the full benefit of her shirking while sharing the cost with the rest of the team. On the other hand, if the team decides to wait and divide up the gains ex post, they may succumb to wasteful "rent-seeking," squabbling over which member is entitled to claim a bigger share. Uncontrolled shirking and rent-seeking can reduce and even destroy the economic gains that flow from team production.[35]

Team members solve this problem by delegating authority over the division of production rents and surpluses to an independent group—the board of directors.[36] The team members intend and expect the board to divide the rents and surplus among team members based on each member's contributions to the team. Shares are to be awarded both to create incentives for future contributions to the team effort and to reward past contributions.[37]

Team members do not rely entirely on the board for their compensation. Instead, each member negotiates a contract with the corporation that assures the member of some minimum share. For executives of the corporation, that may be a salary, stock options, severance pay, and other perks. Creditors' contract rights will include payment of interest and repayment of principal, as well as the right to withdraw their investment in specified circumstances. Customers may receive legally binding warranty promises.

Each of the team members, however, expects something more.[38] That something may vary with production requirements, firm success, the team member's actual contribution, and other factors. For executives, it may be extra bonuses, corporate jets, or club memberships. For bank lenders, it may be either the continuation of the lending relationship even when the bank cannot offer the best terms, or the corporation's pursuit of less risky projects than are permitted under the loan documents. For employees, it may be

---

35. Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction,* 24 J. CORP. L. 743, 745 (1999). Shleifer & Summers make almost the same point. Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers, in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 37 (Alan J. Auerbach ed., 1988) ("[I]t is important to the shareholders that the stakeholders do a good job, but shareholders may be unable to describe what specific actions this calls for, let alone to contract for them.").

36. Blair & Stout, *supra* note 6, at 271-77 (describing how the delegation overcomes the contracting problem).

37. *E.g.*, Blair & Stout, *supra* note 33, at 415 ("Employees and managers usually make these investments because they believe that in the long run, the firm will reward them with raises, promotions, and job security.").

38. *See supra* note 35 and accompanying text.

Christmas bonuses, company picnics, above-market wages and benefits, or continued employment when the employee is so old or sick that the corporation could do better in the marketplace. For customers, it may be product support beyond that promised in the contract, or continuation of that support beyond the time when it is cost-effective for the corporation to provide it.[39]

Team members generally understand that they have no legal right to this something more.[40] If the corporation does not provide it, they cannot sue. Team members also understand that the size and shape of the something more will change with the changing fortunes and circumstances of the firm. But the team members nevertheless regard it as an entitlement. It is not a gift; it is a quid pro quo. Failure to provide this quid pro quo would be a betrayal. It is one for which the team member will have no legal remedy, but it is a betrayal just the same.

Team members choose to trust the board in part because they cannot trust each other. Board members receive salaries and perks, and may own some small amount of stock. But corporate law restricts their right to enrich themselves at the expense of the corporation.[41] Board members cannot usurp corporate opportunities or control decisions in which their own interests conflict with those of the corporation. They are not residual claimants under the team production contract.[42] To put it most bluntly, directors can steal, but directors cannot steal much. Those are the conditions most conducive to the fulfillment of a trust obligation.[43]

Although team members can renegotiate their individual contracts with the firm, they cannot renegotiate the Team Production deal. Once team members have made their firm-specific contributions, they lack the leverage necessary to renegotiate.

The alternative to trusting the board would be to trust one of the team members. None, however, is likely to be as trustworthy as

---

39. The firm is likely to justify its provision of such support as in the long range interests of the firm because it creates customer goodwill. That may not, however, be the true calculus. Even if the board were shown that the firm would never recoup the expenditures from customers, the board might make them anyway from a sense of obligation. To put it more formally, the expenditure is not ex post efficient, but it is ex ante efficient.

40. Blair & Stout, *supra* note 6, at 285 (describing the team's reasons for eschewing legal recourse); Shleifer & Summers, *supra* note 35, at 37 ("[T]he corporation must be trusted to deliver on the implicit contracts even without enforcement by courts.").

41. Blair & Stout, *supra* note 6, at 315 ("[C]orporate law encourages directors to serve their firms' interests *by severely limiting their abilities to serve their own.*" (Emphasis in original)).

42. This principle is violated when employees of the firm serve as "inside" directors or when directors have substantial shareholdings.

43. Blair & Stout, *supra* note 33, at 441-44 (explaining the importance of removing director's opportunities for self-gain).

the board. Each team member who might possibly serve as trustee has a massive conflict of interest that would corrupt not only the division of rents and surplus, but corporate decision making as well.[44] Shareholder representatives would adopt inefficiently risky business policies; creditor representatives would adopt inefficiently conservative ones. Employee representatives might maintain wages and employment at the expense of other team members. Every decision would be suspect.

For this trust-the-directors approach to work, directors must have independence from the team members. They must not govern at the sufferance of shareholders, managers, or creditors. Those constituencies cannot have control over the board except in the most extreme circumstances. Thus, team production is what Professor Steve Bainbridge refers to as a "director primacy" theory.[45] As Blair and Stout put it, directors "are not subject to direct control or supervision by anyone, including the firm's shareholders."[46]

B. Competing Theories

Director primacy theories such as the Team Production Theory conflict with the shareholder primacy theories currently in vogue among law and economics scholars. Shareholder primacy theories regard the shareholders as the owners of the corporation and directors and officers as their agents, "mere stewards of the shareholders' interests."[47] Shareholder primacists argue that because the shareholders elect the directors, the directors serve at the shareholders' pleasure.

Blair and Stout respond that the election mechanism does not function in the modern public corporation.[48] Team members, including the shareholders themselves, have deliberately disabled it.[49]

44. Blair & Stout, *supra* note 6, at 271-74 (explaining the delegation).

45. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 549-50 (2003).

46. Blair & Stout, *supra* note 6, at 290.

47. Bainbridge, *supra* note 45, at 547.

48. Blair & Stout, *supra* note 33, at 434 ("[A]s a practical matter, the casting of sharebolder votes in most public corporations is a meaningless rite.").

49. For example, founders set firms up in such a manner that the firm will pay the board's expenses in a proxy fight, but not the challengers'. The effect is to make proxy fights impractical. *E.g.*, Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests,* 78 CAL. L. REV. 1073, 1106 (1990) ("Only a few reported cases have dealt with reimbursement of proxy contest expenses. Courts largely have left the decision of whether to reimburse contestants to the discretion of the board of directors. Consequently companies generally pay all the expenses for the reelection campaign of incumbents, but reimburse challengers only if they gain control over the board of directors.").

Directors of public companies nominate, and effectively elect, themselves and their successors. Shareholders are nearly powerless to contest elections, and that is how the shareholders want it.[50] In theory, a single person or entity could take over the company by acquiring a block of stock sufficiently large to elect directors. But in practice, Blair and Stout maintain, hostile takeovers occur only in the most extreme circumstances because directors—with the consent of shareholders—have deployed anti-takeover devices.[51] The shareholders tolerate broken election machinery and anti-takeover devices, Blair and Stout maintain, to provide other members the assurance they need to join the team. Managers, employees, creditors, and others would shun a public corporation in which shareholders retained the ability to extract every dollar of rents and surplus for themselves.[52]

Formally, boards of directors hire and fire CEOs and other top executives. Managerialist theories maintain that the relationship works just the opposite: CEOs and top executives capture and control their boards.[53] The Team Production Theory is based on the empirically testable assumption that directors generally dominate the relationship. As Blair and Stout put it, "It is the board, and not the professional managers, that retains the power to control major decisions in most large firms . . . ."[54] There is considerable reason to believe that this assumption is correct.[55]

---

50. Blair & Stout, *supra* note 33, at 445-46 ("[T]eam production analysis suggests that shareholders as a class are better off if they "tie their own hands" by ceding control of the firm to a mediating board . . . .").

51. Blair & Stout, *supra* note 33, at 434 ("[H]ostile takeovers—whether attempted through tender offers or proxy battles—are difficult, risky, and expensive. Shareholders' theoretical ability to 'vote with their feet' in the market for corporate control thus seems likely to impose only a modest constraint on [directors]. . . ."); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 854-55 (2003).

52. In most privately held firms, shareholders do maintain that control. Presumably, privately held firms must have other means for inducing members to join in team production. Blair and Stout limit their Team Production Theory to public corporations, but discuss the private firm problem separately. Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1799-1807 (2001).

53. Bainbridge, *supra* note 45, at 548 ("Managerialism perceives the corporation as a bureaucratic hierarchy dominated by professional managers. Directors are figureheads, while shareholders are nonentities. Thus, under managerialist models, managers are autonomous actors.").

54. Blair & Stout, *supra* note 33, at 425.

55. *See, e.g.*, Bainbridge, *supra* note 45, at 562 ("The board capture phenomenon seems less valid today, however, than it once was. During the 1980s and 1990s, several trends began to encourage more active and effective board oversight.").

Blair and Stout regard Team Production as both a positive and a normative theory.[56] As positive theory, Team Production purports to describe the actual understanding among members of the corporate team. The theory could be refuted by showing the existence of substantial numbers of contracts that are not in accord with its predictions. The theory predicts that contracts granting a single team member—such as shareholders—effective control over a public company's board will be rare.

As normative theory, Team Production purports to be the most efficient and therefore the most desirable basis on which to organize firms that will solicit capital from public equity markets. The claim is not absolute efficiency. Blair and Stout expressly acknowledge that surrender of power to the board is a second best solution.[57] But they assert that team production contracting dominates public corporations because it is the best solution to the team production problem available under the constraints of current technology, laws, and institutions.

IV. THE TEAM PRODUCTION THEORY OF BANKRUPTCY REORGANIZATION

The Team Production Theory of Bankruptcy Reorganization that I propose here incorporates the assumptions underlying Blair and Stout's Team Production Theory of Corporate Law. The bankruptcy reorganization theory adds to the corporate law theory the assertion that the team production contract continues in force during bankruptcy reorganization. The rationale for this addition is that the team members intended that result at the time they contracted. Preservation of the firm's going concern value usually requires that much of the team remain in place and continue to produce during a reorganization effort, but adjustments to the team production arrangement may be necessary. For example, the team may need to fire and replace its managers—or pay them bonuses to stay. Team members are not, however, in a position to negotiate the necessary adjustments. Many are already irrevocably committed to the firm. Instead, team members long before delegated the adjustment process to the discretion of the board.

---

56. *E.g.*, Blair & Stout, *supra* note 33, at 444 ("[D]irectors of public firms not only enjoy, but should enjoy, a remarkable degree of freedom from the commands of shareholders. . . . ").

57. Blair & Stout, *supra* note 6, at 250 ("We argue that public corporation law can offer a second-best solution to team production problems . . . .").

A. Incorporation of Bankruptcy Reorganization in the Team Production Contract

The team production contract entered into at the founding of the public company permits resort to bankruptcy reorganization. By doing so, it deliberately incorporates the provisions of existing bankruptcy law. This may surprise readers who consider bankruptcy a non-optional imposition on creditors.[58] Contracts that seek to opt out of bankruptcy are disfavored in law. Attempts to opt out directly are generally thought to violate public policy.[59] This is for good reason.[60] At the time of contracting, even relatively sophisticated corporate borrowers and their lenders can underestimate the need for, and benefits of, bankruptcy.[61] The most important of these needs and benefits is to keep the team together and thus preserve the going concern value of the business—even when the corporation cannot meet its obligations to creditors.

The contracts that are effective in insulating a lender from bankruptcy are necessarily somewhat convoluted. Among them are contracts that lock control of the board of directors on default such that the board cannot authorize a bankruptcy filing, contracts that give voting control of the corporation to creditors on default, contracts that give creditors leverage against control persons, contracts that isolate collateral in separate entities within corporate groups,

---

58. *See, e.g.*, Lucian Arye Bebchuk & Andrew T. Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 J.L. & ECON. 775, 801 (1999) ("Because it is not possible to contract out of the bankruptcy laws, however, this solution is not available to firms."); James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 995 (1983) ("One simply cannot contract out of the bankruptcy power."); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1833 (1998) ("Because bankruptcy contracts are currently illegal, there is no data about real contracts that could support this argument. The goal here is to render plausible the view that bankruptcy contracting would occur if it were permitted.").

59. *E.g.*, *In re* Tru Block Concrete Prods., 27 B.R. 486 (Bankr. S.D. Cal. 1983) (declining to dismiss a bankruptcy case to enforce a contract that barred the debtor from filing bankruptcy).

60. The contract that eliminates bankruptcy can be a contract with a single creditor. That would create no problem in a world of perfect information and zero transaction costs. Creditors disadvantaged by the elimination would contract to prevent elimination contracts. Even though a no-elimination regime is the probable equilibrium, the web of no-elimination contracts does not yet exist. Until it does, the opportunity exists for a debtor and a single creditor to contract for a suboptimal elimination.

61. Bankruptcy is an arcane institution. For most kinds of loans, the risk that contract provisions with respect to bankruptcy will meaningfully affect recoveries is not sufficiently high to warrant attention. Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 237-42 (1997) (reporting interview responses showing creditor indifference to bankruptcy rules). As a result, market forces may be ineffective in determining the bankruptcy provisions of lending contracts.

contracts placing key assets in bankruptcy-ineligible entities, prepetition agreements to lift the automatic stay in the event of bankruptcy, and asset-securitization contracts.[62]

Asset securitization illustrates the general nature of these contracts. In the typical asset-securitization transaction, the debtor sells assets and then contracts to continue using them. Through a complex arrangement, multiple parties replicate for borrower and lender the effect of a secured loan in the form of an absolute transfer of ownership.[63] Virtually any—or all—of a debtor's assets can be sold, securitized, and leased back.[64] If the borrower later files bankruptcy, the securitized assets are unavailable to the bankruptcy court because their owner is not bound by contract to permit the debtor to continue using them. If the effect is to prevent reorganization, no reorganization occurs.

True asset-securitization transactions—unlike secured credit transactions—*are* intended to insulate the lender from the borrower's later bankruptcy. For the investors, "bankruptcy remoteness" is the essence of the deal.[65] It follows that a lender who structures its transaction as an asset securitization has not agreed to be subject to bankruptcy. The Team Production Theory of Bankruptcy Reorganization would honor that choice. But it just as certainly follows that a lender who structures its transaction as a secured loan has agreed to be subject to bankruptcy. For parties as sophisticated as those involved in public corporation lending transactions, acceptance of the default rule—bankruptcy reorganization—is a deliberate

---

62. LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS § 3.08 (4th ed. 2003) (describing each of these devices).

63. Advocates of asset securitization generally deny that the transaction is a loan disguised as a sale, but they readily acknowledge the similarity. *E.g.*, Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 563 (2003) ("The investors, as senior claimants of the trust, get their money back with interest. The company, as residual claimant, receives payment for the financial assets sold to the trust and is entitled to any residual value of those assets once the investors are paid in full. In economic terms, the deal is similar to a secured loan—the quintessential commercial transaction—in which surplus collateral is returned to the debtor once lenders receive principal and interest.").

64. *See, e.g.*, Claire A. Hill, *Whole Business Securitization in Emerging Markets*, 12 DUKE J. COMP. & INT'L L. 521, 525 (2002) (reporting foreign transactions in which the special purpose vehicle "receives as security for repayment of the loan fixed and floating charges over all or substantially all of the borrower's assets and thus becomes a secured creditor of the borrower"). Professor Hill refers to the transaction as "nominally a securitization" but "actually a hybrid between a true securitization and a corporate credit." *Id.*

65. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994) ("The SPV, however, must be structured as "bankruptcy remote" to gain acceptance as an issuer of capital market securities. Bankruptcy remote in this context means that the SPV is unlikely to be adversely affected by a bankruptcy of the originator.").

rejection of the alternatives by which the parties could have avoided bankruptcy reorganization.

Public corporations engage in asset securitization transactions. Legally, they could securitize even the productive assets of the corporation's core business.[66] However, they rarely, if ever, do so. Ordinarily, the assets securitized are accounts receivable—assets which may not be crucial to continued operation of the business. The asset-securitized creditor opts out of bankruptcy. All that prevents other secured lenders from opting out by the same device, Team Production Theory suggests, is the unwillingness of the board to put one team member in a position to capture the rents and surpluses of the entire team.

Thus, even though contracts exist that would exclude the possibility of bankruptcy reorganization, the large majority of contracting parties deliberately choose not to employ them. They prefer a contract that permits resort to bankruptcy reorganization to one that does not. Bankruptcy reorganization, in its currently existing form, is part of the team production contract.

B. Reconciling Team Entitlements With Bankruptcy Entitlements

Mirroring the team production contract, bankruptcy law allows the team production arrangement to continue virtually unchanged during the reorganization process. The board remains in control of the firm. The business judgment rule continues to apply, giving the directors wide latitude in all matters connected with the operation of the business.[67] The peripheral possibility that shareholders might oust the directors remains peripheral. The possibility does, however, change form. For shareholders—whose rights typically are sharply curtailed or extinguished on confirmation of a reorganization plan—bankruptcy reorganization is an end game. As a result, shareholders' incentives to defect from the team production contract by attempting

66. *See* Hill, *supra* note 64, at 525-26 (discussing "whole-business securitizations"); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 25 (1996) (presenting the opinions of commentators on the practical limits in the use of asset securitization).

67. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984) (recognizing that the business judgment rule is used in reviewing motions to reject executory contracts); Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 14 (1989):

> Where no expressly contrary statutory standard exists, the pure business judgment rule dominates bankruptcy jurisprudence about decisions that affect business strategy or tactical legal choices. As a simple proposition, the pure business judgment test is seldom disturbed unless either the choice made imposes a large adverse impact on one group, or tbe nature of tbe business decision threatens to dominate comprehensively the outcome of the case.

to elect a board loyal to them alone are greatly enhanced. But if shareholders attempt to elect a board, the bankruptcy courts are likely to enjoin them.[68] This bankruptcy doctrine is buttressed by the Delaware Chancery Court's recognition that, in "the vicinity of insolvency," a board of directors has "an obligation to *the community of interests that sustained the corporation*, to exercise judgment in an informed, good faith effort to maximize the corporation's long term wealth creating capacity"—not to serve solely the interests of shareholders.[69] As a result, the directors are no more vulnerable to shareholder control during bankruptcy than they were before bankruptcy.

In one important respect, however, the firm's financial distress and bankruptcy do reduce the board's control. In the absence of default and exercise of creditors' rights, the board alone decides when to terminate the team arrangement. The board does so by closing the business or selling it as a going concern to a buyer who does not agree to honor the team entitlements. In bankruptcy, the court also has the power to close the business or order it sold.[70] In practice, the bankruptcy courts rarely do either over the board's objection, so the board remains in full control until it reorganizes, sells, or closes the firm.

By leaving the board in full control, while at the same time limiting creditors and shareholders to their bankruptcy entitlements, the Team Production contract has, in effect, granted the non-legally enforceable entitlements of team member priority over the legally enforceable claims of creditors and interests of shareholders. To understand why this is so requires careful examination of the bankruptcy distribution rights of creditors and shareholders. Those rights exist under two separate provisions of the Bankruptcy Code, the "best interests" test[71] and the "cramdown" test.[72]

---

68. Reported and unreported cases are discussed in Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 694-99 (1993). *See also* Manville Corp. v. Equity Sec. Holders Comm., 801 F.2d 60, 64 (2d Cir. 1986) (stating that "the right to compel a shareholders meeting for the purpose of electing a new board subsists during reorganization proceedings" but acknowledging that such a meeting should be enjoined for "clear abuse" by shareholders).

69. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Co., No. CIV.A. 12130, 1991 Del. Ch. LEXIS 215, at *108-09 (Del. Ch. Dec. 30, 1991) (emphasis added).

70. The route to such a sale is long and treacherous. A creditor must win termination of the debtor's right of exclusivity, then propose a plan that provides for sale, and finally, win confirmation of the plan. The point is, however, that all this can be accomplished without the cooperation of the board.

71. 11 U.S.C. § 1129(a)(7) (2000).

72. 11 U.S.C. § 1129(b)(2).

The amounts of bankruptcy distributions are fixed by proposal and confirmation of a plan of reorganization. The "best interests of creditors" and "cramdown" tests apply in different circumstances, but each sets minimum amounts for the distributions that must be promised to creditors and shareholders under the plan. The cramdown test applies when a class of creditors or shareholders rejects the plan.[73] The court can confirm the plan over the rejection only if the distribution to the class under the plan is in accord with the "absolute priority rule." That rule, in essence, requires that the plan follow absolutely the priorities established by law or contract.[74] The "best interests of creditors" test has broader application, but fixes lower entitlements. This test applies in favor of each individual creditor and shareholder and requires that the plan promise each at least what that creditor or shareholder would receive in a liquidation of the firm under Chapter 7 of the Bankruptcy Code.[75]

1. Cramdown

On first consideration, the cramdown provisions may seem to assure creditors and shareholders that they will receive the entire bankruptcy distribution, leaving no flexibility for distributions based on team production entitlements. But on careful examination, the flexibility becomes apparent. The cramdown test for distributions to shareholders states: "[T]he condition that a plan be fair and equitable with respect to a class includes the following requirements: . . . With respect to a class of interests . . . the plan provides that each holder of an interest of such class receive or retain . . . the value of such interest . . . ."[76] This provision only entitles shareholders to the "value" of their shares.[77] In or out of reorganization, the value of shares is the present value of all future earnings remaining after allowance for the entitlements of creditors. Earnings are what is left of revenues after expenses have been paid. Team production entitlements are paid as expenses, whether or not the firm is in bankruptcy. Thus, the value guaranteed shareholders by the cramdown test is only the value remaining after team production entitlements have been paid. In other words, team production entitlements, like other expenses, have a claim on the earnings stream that is prior to that of shareholders. That treatment is appropriate

73. DAVID G. EPSTEIN ET AL., BANKRUPTCY § 10-17 (1993).

74. *Id.* § 10-21.

75. *Id.* § 10-18.

76. 11 U.S.C. § 1129(b)(2)(C).

77. *Id.*

because honoring team production entitlements is efficient. We know that honoring team production entitlements is efficient because those entitlements are payable under the team production contract and the team production contract is the bargain actually struck by team members.

The cramdown test for distributions to unsecured creditors provides:

> [T]he condition that a plan be fair and equitable with respect to a class includes the following requirements: . . . With respect to a class of unsecured claims . . . The plan provides that each holder . . . receive property of a value . . . equal to the allowed amount of such claim; or the holder of any claim or interest that is junior to the claims of such class will not receive or retain . . . any property.[78]

This provision requires only that the plan give unsecured creditors absolute priority over shareholders. When shareholders receive nothing, any distribution to unsecured creditors satisfies the test.

Secured creditors have the strongest rights in cramdown. The relevant provision states that

> the condition that a plan be fair and equitable with respect to a class includes the following requirements: . . . With respect to a class of secured claims . . . that each holder . . . receive . . . deferred cash payments . . . of a value . . . of at least the value of tbe holder's interest in the estate's interest in [the collateral].[79]

This provision entitles secured creditors to the value of their collateral. But when valuation takes place in the context of reorganization, even the value of collateral will be fixed with reference to earnings[80]—earnings calculated *after* the payment of team entitlements.

To illustrate, assume a debtor that owes a claim of 100 to a secured creditor. Assume further that the collateral is a hospital worth 65 in liquidation, 70 in continued operation that includes unprofitable community service, and 75 in continued operation that does not.[81] The directors wish to continue operations, including the community service, based on an implicit understanding between the local government and the debtor for reciprocal support. Specifically, the local government "invested" in the hospital corporation in the past by building streets, relaxing regulations, granting tax breaks, and extending services. The understanding was that the corporation would

78. 11 U.S.C. § 1129(b)(2)(B).

79. *Id.* § 1129(b)(2)(A).

80. 11 U.S.C. § 506(a) ("Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditors' interest.").

81. The costs of liquidation are assumed to be 10, which accounts for the difference between the value in liquidation and the value in unencumbered operation.

continue to serve the community. No legal obligation to do so was created, but to cement the relationship, prominent members of the community became members of the hospital corporation's board.

How should the hospital be valued for cramdown purposes? The Bankruptcy Code provides that the holder of a secured claim is entitled to the "value of [the] holder's interest in the estate's interest in [the] property."[82] In short, the secured creditor is entitled to a distribution equal to the entire value of the hospital. That value was assumed to be 75 in certain circumstances, but those circumstances will not occur. The Bankruptcy Code requires that the value of collateral be determined "in light of the purpose of the valuation and of the proposed disposition or use of [the collateral]."[83] Here, the proposed disposition or use is the operation of a community hospital. Accordingly, the value of the hospital for cramdown purposes is 70.

The directors have both the right and the duty to meet the corporation's obligation to the community. Their right derives from their authority to operate the business.[84] Team Production Theory tells us that leaving directors free to meet legally nonbinding obligations to team members maximizes the value of the firm ex ante, by giving effect to the Team Production bargain. Permitting a single team member—here the secured creditor—to expropriate the team's rents and surpluses for itself denies effect to that bargain. Admittedly, if the hospital is the only asset of the bankruptcy estate, this course will not maximize the value of the estate. But if the Team Production Theory is correct, one cannot maximize both the ex ante value of the firm and the ex post value of the bankruptcy estate.

To put it another way, the directors acting as debtor-in-possession have the authority to commit the corporation to continued service to the community. Their decision to do so is protected by the business judgment rule.[85] Once they have done so, the building is worth 70, and that is the value to which the secured creditor is entitled. This does not violate the secured creditors' contract, because the secured creditor voluntarily elected the operation of the bankruptcy process in the event the board invoked it.

---

82. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (describing the standard for cramdown of a reorganization plan against an objecting secured creditor).

83. 11 U.S.C. § 506(a).

84. 11 U.S.C. § 1108 authorizes "the trustee" to operate the dehtor's business during reorganization. The board is the trustee for this purpose. *See* Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994).

85. *See supra* note 67 and accompanying text.

2. Best Interests

Distributions under a plan of reorganization must meet not only the cramdown test, but the "best interests" test as well. That test entitles creditors and shareholders to value under the plan not less than they would receive in a hypothetical liquidation of the debtor under Chapter 7 of the Bankruptcy Code.[86] Because the test is a hypothetical liquidation, no allowance can be made under the test for the payment of team production entitlements. On its face, the best interests test clearly and unambiguously gives a priority to creditors and shareholders.

Some bankruptcy scholars consider the liquidation value of a firm to be equal to the firm' reorganization value. That is, they believe that bankruptcy courts can "liquidate" businesses by selling them as going concerns in Chapter 11 for their full going concern value.[87] One who holds that belief might conclude that no value at all remains available for application to team entitlements.

That issue need not be resolved, however, because the best interests of creditors test does not entitle creditors and shareholders to the full price paid in an hypothetical liquidation by the board under Chapter 11. It entitles them only to the net proceeds, after payment of selling costs, in a hypothetical liquidation by a trustee under Chapter 7.[88] A hypothetical Chapter 7 trustee theoretically could continue to operate the firm and sell it as a going concern.[89] But in practice, going concerns rarely file under Chapter 7,[90] in part because Chapter 7 is

---

86. 11 U.S.C. § 1129(a)(7) ("The court shall confirm a plan only if all of the following requirements are met: ... With respect to each impaired class of claims or interests ... each holder ... has accepted the plan or will receive or retain ... property of a value ... not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title ....").

87. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 786-87 (2002) (arguing that liquidations not only can, but already have, replaced reorganizations); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 645, 699 (2003) ("Any going concern surplus can be captured for creditors via a sale."). *Contra* Lynn M. LoPucki, *The Nature of the Bankrupt Firm*, 56 STAN. L. REV. 645, 666-70 (2003) (explaining why sales sometimes destroy value rather than capturing it).

88. *See* discussion *supra* note 82.

89. *See* 11 U.S.C. § 721 2000("The court may authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interests of the estate and consistent with the orderly liquidation of the estate.").

90. Of 695 cases filed by large, public companies under United States bankruptcy law since October 1, 1979, only one was filed under Chapter 7. Lynn M. LoPucki, Bankruptcy Research Database, *at* http://lopucki.law.ucla.edu (last visited May 17, 2004). Read-Rite filed a Chapter 7 case in Oakland, California, June 17, 2003, and the trustee successfully sold the business as a going concern on July 24, 2003. Olaf de Senerpont Domis, *Western Digital Gets Read-Rite*, THE DEAL, July 25, 2003, LEXIS NEWS Library CURNWS file.

missing provisions necessary to make sale as a going concern feasible for most firms. In the case of a public corporation, at least, the liquidation contemplated by the best interests of creditors test is the piecemeal liquidation of the assets of a closed business.[91] The liquidation values to which creditors and shareholders are entitled under the best interests of creditors test are thus far below reorganization values.[92] Those liquidation values do place theoretical limits on the amounts for which team production entitlements have priority. Those limits, however, are seldom relevant in the determination of actual distributions. If the firm continues to operate, assets will nearly always be sufficient both to satisfy team entitlements and to assure creditors and shareholders of eventual payment of the liquidation values to which they are entitled.

C. Reorganization for Whose Benefit?

The preceding subpart demonstrated that the recognition of team production entitlements in bankruptcy is not inconsistent with the full recognition of both the legal and contractual rights of creditors and shareholders. That argument frees the board to honor the team production contract, but does not tell them what to do with their freedom.

Team production entitlements are entitlements to "rents and surpluses." One might suppose that a firm that cannot meet its obligations to creditors under nonbankruptcy law has no rents and surpluses. That supposition, however, ignores the contract between debtor and creditors that permits resort to bankruptcy. Creditors have agreed to bankruptcy and, accordingly, to receive only that to which they are entitled under bankruptcy law and process. If the claims of creditors and shareholders are reduced to those minimums, rents and surpluses exist. Whether the board should reduce the claims to those minimums is a matter confined to the board members' business judgment. Consistent with this analysis, Congress did not determine

---

91. *See, e.g.*, JACKSON, *supra* note 13, at 224 (acknowledging that selling firms as going concerns under Chapter 7 "would require changes in other legal rules"). *But see* Baird, *supra* note 31, at 139 ("Nothing in current law, however, prevents a sale of the firm as a going concern in Chapter 7 . . . ."). Presumably, Baird means only that the law does not bar such sales, not that such sales are practical.

92. Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 172 (1990) (quoting disclosure statement estimates of the liquidation values of solvent firms that ranged from "little or nothing" to 77 cents on the dollar); *see also* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 177-83 (1997) (reporting huge benefits to secured creditors from their debtors' liquidation of collateral in the ordinary course of business).

entitlements to the excess of going concern value over liquidation value, but left that determination to negotiations among the parties. One of those parties is the board, acting for the debtor in possession. The House Report on the Bankruptcy Reform Act of 1978 states,

> The bill does not impose a rigid financial rule for the plan. The parties are left to their own to negotiate a fair settlement. The question of whether creditors are entitled to the going-concern or liquidation value of the business is impossible to answer. It is unrealistic to assume that the bill could or even should attempt to answer that question. Instead negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders. The bill only sets the outer limits on the outcome: it must be somewhere between the going-concern value and the liquidation value.[93]

One objective of the team production contract is to permit the debtor to remain in business at the time of bankruptcy. From the standpoint of efficiency, the debtor *should* remain in business if the total benefits to team members from continued operation exceed the total benefits to team members from liquidation. In other words, reorganization should occur when it benefits the members of the team in the aggregate. Because the firm's decisions will affect some people who are not members of the team, this standard will permit the firm to externalize some costs, but the amount will be far below the amounts permitted under the Creditors' Bargain Theory.[94]

A second objective of the team production contract is distributional. Each team member has authorized the board to honor the commitments the firm made to other team members in order to induce them to join the team. If necessary, the firm should use bankruptcy to reduce its formal obligations to creditors and shareholders sufficiently to meet those commitments. In seeking that reduction, the firm becomes an adversary to creditors and shareholders with respect to their formal claims, but continues to represent them as a fiduciary with respect to their team production entitlements.

93. H.R. REP. NO. 95-595, at 224 (1978).

94. The Creditors' Bargain theory permits the firm to externalize the same costs as the Team Production Theory and, in addition, the costs incurred by team members other than creditors and shareholders to generate the entitlements that the Creditors' Bargain theory will dishonor.

V. COMPARING THE CREDITORS' BARGAIN AND TEAM PRODUCTION THEORIES

Baird and Jackson have presented the Creditors' Bargain Theory as both a positive and a normative theory of bankruptcy.[95] This Part argues that the Team Production Theory is better on both accounts. That is, Team Production better explains existing bankruptcy reorganization institutions, and, to the extent those institutions are in fact the choice of the contracting team members, better describes the forms that bankruptcy institutions should take.[96]

A. Whose Interests Should Bankruptcy Serve?

Whose interests bankruptcy should serve has been hotly contested between Creditors' Bargain theorists and traditional bankruptcy scholars. Professor Elizabeth Warren is one of many who have argued that the purposes of bankruptcy reorganization include saving jobs and companies for the benefit of numerous impacted constituencies, not just creditors:

> Bankruptcy policy also takes into account the distributional impact of a business failure on parties who are not creditors and who have no formal legal rights to the assets of the business. Business closings affect employees who will lose jobs, taxing authorities that will lose ratable property, suppliers that will lose customers, nearby property owners wbo will lose beneficial neighbors, and current customers who must go elsewhere. Congress was acutely aware of the wider effect of a business failure on the surrounding community and it adopted the 1978 Bankruptcy Code specifically to ameliorate those harmful effects. . . .[97]

---

95. A positive theory seeks to "explain" observed phenomena by demonstrating that it is consistent with the theory. *E.g.*, Thomas H. Jackson & Robert E. Scott, *An Essay on Bankruptcy Sharing and the Creditor's Bargain*, 75 VA. L. REV. 155, 179 (1989) ("We now consider whether a richer version of the creditors' bargain better explains the apparent tensions that mark these features of federal bankruptcy law."). A normative theory attempts to state what is desirable. *E.g.*, Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 750 (1984):

> The creditors' bargain model, which provides a framework for analyzing that relationship, suggests that using nonbankruptcy entitlements, valued at the date of bankruptcy, should constitute the normative baseline for valuing bankruptcy entitlements and that a collective proceeding must upset only those rules that work to the detriment of the creditors as a group.

96. Because government offers contracting parties a limited menu of bankruptcy options, their choice of one does not prove the one optimal. But in a general sense, at least, the options offered are themselves the winners of a competition and so entitled to some credence. *See* Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 413 (1990) (asserting that "[e]nduring legal institutions endure eitber because they are efficient or because they redistribute wealtb to concentrated, politically effective interest groups"); *id.* at 412 (arguing that bankruptcy reorganization is in the former category).

97. Elizabeth Warren, *Bankruptcy Policymaking in an Impcrfect World*, 92 MICH. L. REV. 336, 354-55 (1993).

Consistent with Team Production Theory, Warren acknowledges that "the Code protects the interests of parties without formal legal rights only indirectly" by protecting the debtor and the business from creditors.[98] Inconsistent with the Team Production Theory, however, Warren regards bankruptcy as deliberately redistributional.[99]

Others have also sought to justify bankruptcy's service of a broad range of interests. Professor Nathalie Martin advocated direct recognition of the interests of persons with "noneconomic rights"[100] and Professor Karen Gross did the same with respect to "community interests."[101] Neither, however, has been able to explain adequately how a bankruptcy court would weigh these interests against one another or against the interests of creditors and shareholders.[102]

The Team Production Theory is essentially in agreement with these scholars as to the interests to be served by bankruptcy. It adds, however, both a new explanation for the service and a new standard for determining the limits of the obligation.

Under the Team Production Theory, the bankrupt firm should honor its obligations to all who made firm-specific investments at the invitation of the firm and could not protect them in other ways. This rationale might extend to any of the persons mentioned in the Warren quotation. It might justify the retention of particular long-term employees, for example, despite the fact that others were now available to work more cheaply. It might justify the payment of "retention bonuses" of the type that have recently become common in reorganization cases. It might also justify continuing to operate the business in a community where costs were higher than in some alternative location. The firm-specific investments so recognized might include the expenses incurred by employees and suppliers in moving to the community to join the team, or tax concessions made by the local taxing authority to attract the debtor to the community. They might also include the investments and efforts consumers of computer

98. *Id.* at 355-56.

99. *Id.* at 353 ("[W]hen bankruptcy law deviates from a strict equality principle, it does so for self-consciously redistributive ends."). Professor Ronald Mann responded to Warren by offering one theory as to why bankruptcy might not be redistributional: reorganization value belonged to the government, whose legal machinery created it. The government cedes that value to the parties as part of the bankruptcy process. Mann, *supra* note 22, at 1032-38.

100. Nathalie D Martin, *Noneconomic Interests in Bankruptcy: Standing on the Outside Looking In*, 59 OHIO ST. L. REV. 429 (1998).

101. *See* Gross, *supra* note 84.

102. *See* Barry S. Schermer, *Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy: A Modern-Day Tale of Belling the Cat*, 72 WASH. U. L.Q. 1049, 1050-52 (1994) (arguing that bankruptcy judges could not practically weigh community interests and that in trying they might come in conflict with legislatures).

products make when they buy and learn to use products. In each of these cases, the firm invited the investment and the investor placed trust in the directors to reciprocate. Meeting these obligations does no violence to the rights of team members who do have legal rights against assets, because the holders of the legal rights have contracted that the obligations to the team be met.

The members of the board of directors, acting as fiduciaries, decide which of these claims to recognize and how much to pay the claim holders. In making the decision, the board is protected by the business judgment rule.[103] Under the rule, dissatisfied claimants have a remedy only if the directors yield to conflicting interests, fail to inform themselves to the extent they reasonably deem necessary, or act in bad faith.[104] Even when someone is entitled to reverse the board's actions, the courts do not decide who is entitled to money. They only decide who is not, by invalidating or declining to authorize particular payments.[105]

Creditors' Bargain theorists acknowledge that "the notion of keeping firms in business seems to be meant as an independent policy."[106] They nevertheless apply their theory to reject that policy, concluding that bankruptcy exists solely for the benefit of creditors and shareholders.[107] Consistent with this narrow conception of the interests to be served, the Creditors' Bargain Theory seeks maximization of "the value of a given pool of assets"[108] ex post, rather than the value of the firm ex ante. Positively and normatively, that statement of the objectives of bankruptcy reorganization is too narrow.

---

103. *See* Nimmer & Feinberg, *supra* note 67, at 1.

104. That is, the business judgment continues to shield the board after bankruptcy as it did before. *See id.*. For a general statement of the rule, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 6.4.B (2002).

105. 11 U.S.C. § 1108 authorizes the "trustee" to "operate the debtor's business" during the bankruptcy case unless the court orders otherwise. The debtor in possession generally has the rights and powers of a trustee. 11 U.S.C. § 1107(a) (2000). The "debtor"—that is, the corporation that filed the case—is the debtor in possession. 11 U.S.C. § 1101(1). Through its agents, the board acts for the corporation. Thus, in effect, the board has substantially the rights and powers of a trustee. The board generally will seek authorization from the court to make payments outside the ordinary course of business. The court's role is confined to ruling on those requests and voiding payments not authorized by the court or the Code. 11 U.S.C. § 549(a).

106. JACKSON, *supra* note 13, at 25.

107. *Id.* ("[W]orkers . . . are not owners with substantive rights against the assets. For that reason the owners are free to close the business without considering the interests of the workers if doing so brings the owners more money.").

108. *Id.* at 24.

1. Comparison as Positive Theory

With respect to the interests served, the Team Production Theory can be compared to the Creditors' Bargain Theory on at least three criteria: (1) how well each describes the statutory scheme, (2) how well each reflects the intent of the statutory scheme as described in legislative history and court opinions, and (3) how well each describes the actual pattern of outcomes in bankruptcy cases. Little evidence is available with respect to the third criteria,[109] so this discussion is limited to the first two.

Consistent with the Creditors' Bargain Theory, the text of the bankruptcy code provides distributional entitlements only to creditors and shareholders.[110] Inconsistent with that theory, however, the Bankruptcy Code in some instances recognizes that persons other than creditors and shareholders may be "parties in interest" whose interests must be considered.[111] But the major inconsistency between the text of the Code and the tenets of the Creditors' Bargain Theory are the provisions that leave the board of directors in control of the firm during reorganization.[112] Board control of an insolvent firm is a feature of Chapter 11 for which the Team Production Theory can account and for which the Creditors' Bargain Theory cannot. If bankruptcy is to serve only the interests of the creditor-owners, why should a board supposedly elected by shareholders remain in control of the firm?

The legislative history of the Bankruptcy Code and court opinions interpreting it both indicate that the interests to be served under Chapter 11 are not confined to those of creditors and shareholders.[113] The legislative history, for example, states,

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. . . . It is

---

109. To be useful in such an evaluation, the data would have to support a distinction between (1) actions taken in reorganization for the benefit of creditors and shareholders, and (2) actions taken in reorganization contrary to the interests of creditors and shareholders, for the benefit of others. In practice, that distinction would be difficult to make. Actors usually describe their actions as serving the interests of both groups simultaneously.

110. *E.g.*, 11 U.S.C. § 1129(b)(2) (cramdown provisions specifying entitlements only for creditors and shareholders).

111. *E.g.*, 11 U.S.C. § 1104(a)(2), discussed *infra* note 129 and accompanying text.

112. *See supra* note 103 and accompanying text.

113. *E.g.*, Richard V. Butler & Scott M. Gilpatric, *A Re-Examination of the Purposes and Goals of Bankruptcy*, 2 AM. BANKR. INST. L. REV. 269, 284 (1994) ("Though Congress did not address the problem of preserving external going concern value as such, it was certainly concerned with ameliorating the impact of business failures on employees, the parties with whom a firm contracts, and the surrounding community.").

more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.[114]

In language often quoted by the lower courts, the Supreme Court opined that "The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."[115] Not only do the courts see Chapter 11 as expressing a preference for reorganization over liquidation, that preference is not based solely on the relative values generated for the owners of the firm.[116] Preservation of the firm is an independent value that partially accounts for the choice.[117] The Team Production Theory of Bankruptcy Reorganization reflects these values; the Creditors' Bargain Theory does not.

2. Comparison as Normative Theory

The Team Production Theory is premised on an assumed understanding among team members that the board will serve the interests of all team members. Making that assumption, the Team Production Theory's inclusion of all team members among the interests to be served in bankruptcy is normatively superior in two respects. First, it results in deployment of the firm's resources in accord with the ex ante team production contract and is thus efficient. Team members entering into a contract at the time of bankruptcy might choose a different deployment. They would commit their resources to the firm's future, not to paying entitlements the firm granted in return for past contributions. But if directors succumbed to that temptation, they would, at least in theory, trigger a recursive firm crisis. Knowing that past team production entitlements had not been honored, prospective team members would see no reason to believe that future entitlements would be treated differently. With team members unable to rely on team entitlements, those members would be forced to insist on less efficient, legally binding contracts instead. Team production—for some firms the more efficient form of contracting—would cease to be viable as a form of business organization. Professors Shleifer and Summers made this statement

114. H.R. REP. NO. 95-595, at 220 (1977).

115. NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984).

116. *E.g.*, Butler & Gilpatric, *supra* note 113, at 288 ("If Chapter 11 proceedings in fact have some bias in favor of reorganizing a firm, it may simply be a recognition of the external costs of liquidation.").

117. *In re* A & B Heating & Air Conditioning, 823 F.2d 462, 465 (11th Cir. 1987) ("The Code expresses a preference toward reorganization rather than liquidation; a viable reorganization plan typically provides greater payment to creditors while preserving the economic life of the entity.").

in the context of hostile takeovers, but it is equally applicable to bankruptcy reorganization:

> If potential stakeholders believe that their contracts will surely be violated whenever they collect more from the firm than they put in, they will not agree to implicit contracts. Potential suppliers will not invest in relationship-specific capital, the young will shirk if they expect no raise in the future, and firms will be unable to reduce labor costs by offering insurance against uncertain ahility to their workers. Even if breach via takeover is not a certainty but only a possibility, the opportunities for long-term contracting will be limited. To the extent that realizing gains from trade requires such contracting, these gains will remain unrealized and ex ante welfare will be reduced.[118]

This argument is essentially the same one that has long been accepted for honoring creditors' bargains in bankruptcy. The only difference is that Team Production Theory recognizes a wider range of obligations.

The more inclusive Team Production Theory is also normatively superior to the Creditors' Bargain Theory in minimizing the externalization of the firm's costs. Even before the development of the Team Production Theory of Bankruptcy Reorganization, Professor Elizabeth Warren had criticized the Creditors' Bargain Theory for facilitating the externalization of costs.[119] She noted that many of the social costs incurred in the creation of a firm were borne by employees, communities, suppliers, customers, and others. When the firm failed, those parties were left with the costs. The effect was to create an inefficient incentive for creditors to quickly terminate one firm and move on to the next. To Warren's point, Team Production Theory adds the standard for determining which costs the firm should internalize: those incurred by anyone in reasonable reliance on the Team Production arrangement.

B. The Debtor-In-Possession

When a public corporation files for bankruptcy reorganization, the corporation—as "debtor-in-possession"—remains in possession of its property and continues to operate the business. Acting as a fiduciary for all parties in interest, the debtor-in-possession is the principal actor in the case, making required disclosures, formulating and implementing the business plan, negotiating the reorganization plan, and shepherding the plan through the legal process. The dominant role of the debtor-in-possession is reflected in the results of a recent empirical study of professional fees in bankruptcy

118. Shleifer & Summers, *supra* note 35, at 45.

119. Warren, *supra* note 97, at 356 ("[T]he protection of parties without legal rights also reflects a more profound economic reality: the parties with formal legal rights never completely internalize the full costs of a business failure."); *see also* Butler & Gilpatric, *supra* note 113, at 282-84 (discussing the externalization of costs that occurs on liquidation of the firm).

reorganization cases. The study found that 80 percent of the professional fees authorized by the court were incurred by the debtor-in-possession. The remaining 20 percent were divided among creditors' committees, indenture trustees, and equity committees.[120]

During bankruptcy reorganization, the board of directors continues to exist and to exercise the authority it exercised prior to filing. The board remains in control even when the corporation is grossly insolvent.[121] The inconsistency with the shareholder primacy theory should be obvious. If the directors are agents of the shareholders and stewards of shareholder interests, the directors should not be running a business that is now "owned" by the creditors.[122]

The debtor-in-possession doctrine, like the public corporation, is almost uniquely American. In foreign systems, a representative of creditors is usually in charge of the estate.[123] Even in the United States, the debtor-in-possession doctrine was abandoned for a period with respect to large, public companies.[124] The legislative history explains the doctrine as a compromise necessary to induce managers to bring their ailing firms into bankruptcy.[125]

The Team Production Theory explains why directors should and ordinarily do remain in control of even grossly insolvent reorganizing corporations. The directors are not agents of the

---

120. Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. EMPIRICAL LEGAL STUD. 111, 114 (2004).

121. Gross insolvency is not even a ground for the appointment of a trustee. 11 U.S.C. § 1104(a) (2000) (listing the grounds for the appointment of a trustee).

122. "Owned" is Jackson's word. *See supra* note 29 and accompanying text.

123. Evan D. Flaschen et al., *Foreign Representatives in U.S. Chapter 11 Cases: Filling the Void in the Law of Multinational Insolvencies*, 17 CONN. J. INT'L L. 3, 15 (2001) ("However, very few countries have adopted the debtor-in-possession concept, preferring to install a court appointee as manager of the dehtor's affairs.").

124. From 1938 to 1979, the Bankruptcy Act required that large public companies file under Chapter X of the Act. Karen M. Gebhia-Pinetti, *Small Business Reorganization and the SABRE Proposals*, 7 FORDHAM J. CORP. & FIN. L. 253, 258, n.13 (2002) ("Congress intended that . . . large, puhlicly held debtors would file under chapter X."). Chapter X directed that a trustee be appointed in every case. 11 US.C. § 556 (1970) (repealed effective October 1, 1979). The trustee displaced the board, but often hired the former officers. Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 455 (1992) (reporting that "upwards of 70% of managers remained in control of their businesses" in Chapter X cases).

125. H.R. REP. NO. 95-595, at 233 (1977) ("Debtors' lawyers that participated in the development of a standard for the appointment of a trustee were adamant that a standard that led to too frequent appointment would prevent debtors from seeking relief under [the reorganization law] and would leave the [law] largely unused except in extreme cases."); *see also* Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223, 232 (1991) ("By allowing the managers to continue, if only for a time, bankruptcy law ensures that the mangers will not let creditors exercise nonbankruptcy rights of debt collection that will shut down a firm that should survive.").

underwater shareholders. They are instead the fiduciaries entrusted by the team members, including the creditors, to determine the distributions of the team's rents and surpluses.[126]

Why, then, are the creditors and shareholders also represented by committees during the bankruptcy process? The reason is that creditors and shareholders have both Team Production entitlements and legal rights *against* the team. Bankruptcy will alter the latter. The degree of alteration is a matter not committed to board discretion. With respect to those legal rights, creditors and shareholders may be adverse to the board. Consequently, the creditors and shareholders need independent representation.

C. Protecting Board Independence

The Bankruptcy Code says nothing one way or the other about the continuation of corporate democracy during reorganization. Nevertheless, the courts have, in several instances, enjoined shareholders from meeting to elect directors during reorganization.[127] The injunctions have been granted in the cases of both solvent and insolvent corporations. Shareholder Primacy and Creditors' Bargain theorists would have difficulty explaining why the shareholders of a *solvent* Manville Corporation should be enjoined from electing directors who would aggressively pursue shareholder interests in plan negotiations.[128] Team Production theorists would not. They would see the shareholders' attempt to elect a new board that would serve shareholder interests alone as the attempt of a single team member to seize the team's entire rents or surpluses.

Nor does bankruptcy law allow creditors to take control of the reorganizing firm from the board. The bankruptcy court has statutory authority to appoint a trustee in place of the debtor-in-possession, but only for egregious wrongdoing by incumbent management or when "such appointment is in the interests of creditors, any equity security holders, *and* other interests of the estate."[129] Inclusion of a reference to "other interests of the estate," after naming creditors and shareholders, suggests that such interests exist, but are difficult to describe. That is entirely consistent with the Team Production Theory

126. *See supra* Part III.A.

127. *See supra* note 68.

128. The bankruptcy court entered such an injunction. The Second Circuit reversed and remanded for an evidentiary hearing to determine whether the committee was guilty of a "clear abuse" in calling the meeting. Manville Corp. v. Equity Sec. Holders Comm., 801 F.2d 60, 69 (2d Cir. 1986).

129. 11 U.S.C. § 1104(a)(2) (2000) (emphasis added).

of Bankruptcy Reorganizaton. So is the lack of any exception to permit the appointment of a trustee for a clearly insolvent corporation. Chapter 11 trustees are rarely appointed until it is clear that the firm will not continue operations.[130] Also consistent with Team Production Theory, the omission of gross insolvency as a ground for the appointment of a trustee protects the board from even a class of creditors that is the sole residual claimant. Substitution of a court-appointed trustee for the board of a going concern is rare because it deprives the entire team of its contractually chosen trustee and allows creditors to seize the team's entire rents or surpluses.

The Creditors' Bargain Theory is inconsistent with the legal standard for the appointment of trustees. First, the theory holds that bankruptcy exists to serve exclusively the interests of creditors and shareholders. It follows that bankruptcy courts should take no other interest into account in determining whether to appoint a trustee. Yet, to comply with Bankruptcy Code Section 1104(b)(2), the courts must. Second, the Creditors' Bargain Theory teaches that the residual claimants should be in control.[131] In the case of a clearly insolvent corporation, creditors are the residual claimants.[132] It would seem they should be entitled to substitute their representatives for the board of directors. Yet, they are not. The Creditors' Bargain Theory suggests no reason for the scheme of corporate governance recognized in American bankruptcy law: Directors ostensibly selected by shareholders to serve shareholder interests remain in control of even clearly insolvent firms.

D. Plan Negotiations

Creditors' Bargain theorists see creditors and shareholders as the sole "owners" of the firm's assets and thus the only ones whose interests should be taken into account in the reorganization.[133] On that assumption, one would expect representatives of creditors and

---

130. Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 247, 259-60 (1983) (reporting that "[i]n four of the five cases in which a trustee was appointed the debtor had, at the time of appointment, already expressed its unwillingness to continue to operate the business, a sure indication that continuance was not feasible").

131. Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 775 (1988) ("The law of corporate reorganizations should focus on identifying tbe residual owner, limiting agency problems in representing the residual owner, and making sure that the residual owner has control over the negotiations that the firm must make while it is restructuring.").

132. JACKSON, *supra* note 13, at 168 (1986) ("That groups consists of the residual claimants, who in the case of an insolvent company are almost always tbe unsecured creditors.").

133. *See supra* notes 29-31.

shareholders to lead the plan negotiations. The board of directors would have no role except to furnish information to the creditors and shareholders.

In fact, directors take the central role in plan negotiations. They act through managers and professionals. The professionals represent the debtor-in-possession and are barred, legally and ethically, from representing the interests of creditors or shareholders.[134] The Bankruptcy Code gives the debtor-in-possession the exclusive right to file a proposed plan during the first 120 days of the case and such extensions as the court may allow for good cause.[135] In most large, public company reorganizations, the court extends this "exclusivity" right for the duration of the case.[136] In those cases, neither creditors nor shareholders can ever file a plan. Typically, the debtor-in-possession negotiates the plan with representatives of creditors and shareholders. They negotiate as adversaries. In our study of the bankruptcy reorganizations of large, public companies, Professor William C. Whitford and I found that in 11 of 25 cases (44 percent), the managers in charge of the firm[137] saw themselves as aligned with neither creditors nor shareholders. Seven of the 25 managements sought principally to "preserve the company." Four sought to maximize the estate. In two cases the managers of insolvent companies saw themselves as aligned with equity.[138] A Creditors' Bargain theorist can only wonder on whose behalf management negotiates.[139] The Team Production theorist knows: the members of the production team.

Sara Kalin, Joseph Doherty, and I recently discovered and documented high failure rates among firms emerging from bankruptcy reorganization.[140] The frequency of these failures—over half the cases

134. C.R. Bowles, Jr. & Nancy B. Rapoport, *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?*, 5 AM. BANKR. INST. L. REV. 47, 59 (1997) ("Estate Counsel is supposed to owe its allegiance to the Bankruptcy Estate and not to the principals of the Estate.").

135. 11 U.S.C. § 1121(b), (d) (2000).

136. LoPucki & Whitford, *supra* note 68, at 693, 717 n.177 (finding, in a 1993 study of reorganizations of public companies, that in 34 of 43 cases studied, exclusivity was extended for the duration of the case).

137. In our study, we conflated directors and officers. Specifically, we reported on the activities of the CEO.

138. LoPucki & Whitford, *supra* note 68, at 742-47.

139. Jackson, for example, seemed to see no purpose in reorganization negotiations. JACKSON, *supra* note 13, at 223 ("For these reasons the premises for negotiation in a chapter 11 process seem unproven and unpromising.").

140. Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231

in Delaware[141]—combined with the magnitude of the associated operating losses—an amount equal to 18 percent of the firm's reported total assets before bankruptcy for the cases in Delaware[142]—make clear these were not "efficient" failures, but failures in the process of bankruptcy reorganization.[143]

Harvey R. Miller, a leading bankruptcy reorganization counselor, believes these increasing failure rates result from recent changes in the plan negotiation environment. Miller identifies two such changes in particular. First, he asserts that debtors have less leverage in negotiations because the courts have been rushing the cases.[144] Second, Miller charges that "[d]istress debt trading and [resulting] changes in bankruptcy relationships have destroyed the symbiotic relationship of debtor and creditor."[145] Both explanations are consistent with Team Production Theory.

Boards, as representatives of the production team, tend to apply resources to improvements in business operations. They tend to favor reorganization.[146] Senior creditors do better if resources are applied to the payment of legal claims. They tend to favor liquidations that eliminate the competing team entitlement claims. Reducing debtor-in-possession bargaining leverage reduces resources available for business operations and so tends to increase failure rates.

Distress debt trading weakens the team by substituting a financial speculator for a team member. Team members have team obligations as well as team entitlements. At the time of bankruptcy, a creditor's team obligations may be greater than its entitlements. An example might be the bank lender that was allowed to reap high profits in the past on the understanding that the bank would "work

---

(2001); Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 VAND. L. REV. 1933 (2002).

141. LoPucki & Doherty, *supra* note 140, at 1945.

142. LoPucki & Kalin, *supra* note 140, at 236-38.

143. Lynn M. LoPucki, *Can the Market Evaluate Legal Regimes? A Response to Professors Rasmussen, Thomas, and Skeel*, 54 VAND. L. REV. 331, 333-38 (2001) (presenting data on emerging firms' losses from confirmation to refiling).

144. Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2013 (2002) ("Fearing that the bankruptcy court will no longer grant a once routine extension of exclusivity, debtors now are rushed to propose creditor-friendly, economically deficient plans to garner enough votes to pass a plan during the debtor's exclusivity period."). Doherty's and my findings support Miller's assertion. We found an inverse, and statistically significant relationship between the speed of reorganization and the likelihood of failure. The faster the reorganization, the more likely was the emerging firm to fail within five years after confirmation. LoPucki & Doherty, *supra* note 140, at 1975-77.

145. Miller, *supra* note 144, at 2014.

146. Among 25 bankrupt firms Whitford and I studied, the managements of seven (28 percent) put "preservation of the company" ahead of any other objective. LoPucki & Whitford, *supra* note 68, at 742-47.

with" the debtor in difficult times. Sale of the bank's claim to an investor that will consider only the investor's immediate self-interest breaches that understanding and harms the team. Distress debt traders, Miller asserts, "may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments."[147]

The Creditors' Bargain theorist would likely see no relevance in the changes Miller laments. Reorganization law gives classes of interested creditors and shareholders each a veto over any plan that does not afford the class its full rights under the absolute priority rule. The Creditors' Bargain theorist would suppose that a plan that provided less than full payment could not be rushed because any dissatisfied class could veto.

The Team Production theorist, by contrast, would realize that a third interest is at stake: that of the production team. The team's representative, the board of directors, has the exclusive right to file a reorganization plan ("exclusivity") during the first 120 days of the case plus whatever extensions of that period the court grants. Through the 1980s, courts generally granted whatever extensions the board requested. Miller's complaint is that in more recent years, courts have been less inclined to grant extensions. The result has been to undermine the ability of the board to assert the interests of the team.

Similarly, the Creditors' Bargain theorist has no reason to believe that the interests of one owner of a class of claims should be materially different from the interests of another owner of the same claims. But a Team Production theorist would recognize the shift in ownership as the substitution of an outsider for a team member and a breach of the non-legally enforceable contract under which the team came together.[148]

E. Is Reorganization Efficient?

When lawyers who reorganize large, public companies explain what they are doing, they often say that they are "preserving the company"[149] in order to save its "going concern value." Creditors' Bargain theorists respond that the going concern value of a firm is not threatened by distress. Sale of the firm as a going concern preserves it. Nothing is lost by sale because a firm, they say, cannot be "more

147. Miller, *supra* note 144, at 2016.

148. *See* Shleifer & Summers, *supra* note 35, at 41 (arguing that hostile takeovers constitute a breach of trust because control goes to a bidder "who is not committed to upholding the implicit contracts with stakeholders").

149. LoPucki & Whitford, *supra* note 68, at 743-45 (reporting such descriptions).

valuable in the hands of its current claimants than it would be in the hands of third parties."[150] For these reasons, the leading Creditors' Bargain theorists prefer that public companies be sold as going concerns rather than reorganized.[151] In the past, defenders of reorganization have responded that mandatory sales would interfere with bankruptcy triggering mechanisms,[152] that markets are too thin to support mandatory sales,[153] and that selling costs would be too high.[154]

The Team Production Theory can justify reorganization even when the firm could be sold for more than its reorganization value. This can be explained two ways. First, to provide an environment in which teams can come together and rely on the mediation of the board, the law must protect the team's expectations. If firms are put "in play" by the filing of a bankruptcy case, those expectations may be frustrated—just as they would be in the context of a nonbankruptcy hostile takeover.[155] That practice violates the Team Production contract, and so interferes with firm formation ex ante.

The second explanation begins by noting that the "reorganization value" of a firm, as commonly computed, includes only distributions to shareholders and creditors. The calculation ignores distributions on team entitlements—the advantages of reorganization to managers, workers, suppliers, customers, taxing authorities, and communities.[156] Selling the firm to a buyer who can pay more only because that buyer can then default on team entitlements reduces rather than increases social wealth.

Team Production Theory is not offended by all sales of firms as going concerns. Entrustment of the firm to the directors includes entrustment for purposes of sale. But the sale should occur only when the directors choose to sell, the unambiguous contract of a team member entitles that member to a sale, or the sale is for the benefit of

---

150. JACKSON, *supra* note 13, at 221.

151. *Id.* at 221-22 ("There is no reason why chapter 7 could not be used as the vehicle to sell the firm as a going concern in the same way that companies go public."); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations,* 15 J. LEGAL STUD. 127, 128 (1986) ("In this paper I ask whether corporate reorganizations should exist at all."); *id.* at 145 ("The thrust of the argument presented in this paper is that the owners of a firm, especially a publicly held firm, would likely prefer a sale of the firm outright to whomever was willing to pay the most for it.").

152. *E.g.*, LoPucki & Whitford, *supra* note 68, at 756-57.

153. *E.g.*, *id.* at 758-65.

154. *E.g.*, *id.* at 753-67.

155. Shleifer & Summers, *supra* note 35, at 53-54 (arguing that hostile takeovers frustrate the expectations of corporate stakeholders under implicit contracts).

156. *See* Butler & Gilpatric, *supra* note 113, at 282-84 (arguing that firms have "external going concern value" that should be preserved along with the "internal" going concern value commonly recognized in economic theory).

a non-team member, such as a tort creditor. The reason is simple: That is the deal the team members made. Not to honor it would introduce inefficiencies.

VI. CONCLUSIONS

Team Production is not a theory with which I feel comfortable. The theory is based on a wholesale grant of unfettered power to directors. My inclination is to think that will not work. Power corrupts, and absolute power corrupts absolutely. The almost daily reports of director fraud, negligence, and indiscretion in the newspapers confirms my inclination. Only a fool would trust corporate directors.

Yet the evidence that Blair and Stout have assembled in favor of their Team Production Theory is impressive. Not only do fools trust directors, nearly everyone does. Team Production does indeed seem to describe how most public corporations function. Team members trust directors not because they think directors will do a good job, but because team members lack better alternatives. As Stout likes to put it, "it's a terrible system—until you consider the alternatives."

Fortunately, Team Production is a falsifiable, and so empirically testable, theory. It maintains that team members—including creditors and shareholders—deliberately tie their hands in dealing with the board of directors. They give up their control over the board to persuade other members to join the team. They trust the board to do "the right thing," even though they cannot define what that is in advance with sufficient specificity to directly contract for it. These are claims researchers can investigate empirically. Ultimately, the evidence may prove the Team Production Theory accurate as to all, or merely some, public companies. Some of the empirical evidence is already in, and it seems strongly to support Blair and Stout's theory. That is reason for taking the theory seriously, whether we like it or not.

Another reason for taking Team Production Theory seriously is that it fits to bankruptcy law and tradition like a hand in a glove. Features that make no sense in the Creditors' Bargain Theory—including the debtor-in-possession, protection of the board from domination by the holder of the residual interests, the board's central role in the negotiation of a plan, the persistent insistence that reorganization benefits society by saving jobs and companies, and the very existence of reorganization—are all explained comfortably in Team Production Theory.

What is at stake in the Team Production debate is nothing less than the direction of the giant corporations that form the core of the American economy. Those corporations are, for the most part, controlled by independent directors who have been given the freedom to do what they think is right. If the shareholder primacists win this debate, independent directors—in or out of bankruptcy—should use that freedom in the service of shareholders or the creditors who are about to become shareholders. But if the Team Production theorists are right, independent directors should use their freedom in the first instance to preserve and continue the firm and in the second to serve all corporate constituencies fairly.

***