THE PROBLEMATIC CASE FOR INCENTIVE COMPENSATION IN BANKRUPTCY

ADAM J. LEVITIN[†]

In response to Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777 (2007).

Are carrots better than sticks? Yes, is the assumption underlying pay-for-performance as a means of corporate governance. The economic theory behind pay-for-performance is that managers will maximize a firm's value if their interests are aligned with those of the owners. The implementation of performance-based pay schemes, however, often leaves much to be desired,[1] and psychological research suggests incentive compensation can even have detrimental effects on performance.[2]

Incentive pay analyses have generally focused on normal business operations. There has been little written about the unique problems posed by bankruptcy, where ownership often shifts and the debtor operates under court and creditor supervision. Most proposals for improving corporate governance in bankruptcy advocate fine-tuning various creditor and shareholder constituencies' roles in the reorganization process.[3] There has been little consideration of management

---

[†] Associate Professor, Georgetown University Law Center (starting summer 2007). Associate, Business Finance & Restructuring Department, Weil, Gotshal & Manges, LLP. The author would like to thank John Coates, Megan Cummins, Michael Gadarian, Will Guthrie, Daniel Kelly, Sarah Levitin, Yair Listokin, Judy Liu, Lynn LoPucki, Ronald Mann, Robert Rasmussen, and Elizabeth Warren. The views expressed in this article are solely those of the author. Please send any comments to levitin@post.harvard.edu.

[1] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 6-7 (2004) (discussing findings that performance-based compensation can allow executives to receive substantial rewards regardless of performance).

[2] *See* Dan Ariely et al., *Large Stakes and Big Mistakes* 3-13 (Fed. Res. Bank of Boston, Working Paper No. 05-11), *available at* http://ssrn.com/abstract=774986 (reviewing the research).

[3] *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1236-42 (2006) (explaining how DIP financing can be used as a corporate governance lever); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003) (same); George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Fi-*

incentives in bankruptcy.[4] Yair Listokin's article[5] is thus an important attempt to apply the insights of corporate finance and refocus the corporate governance debate in bankruptcy from the sticks of traditional corporate governance—monitoring by directors, creditors, the United States Trustee, and the court—to the carrots of incentive compensation.

Listokin is concerned that bankruptcy compensation systems encourage self-interested managers to make decisions that do not maximize firm value.[6] For example, if a manager is given stock in the debtor, it creates an incentive to maximize stock value, not firm value. Likewise, if a manager is hoping for continued employment with the debtor or is guaranteed a success fee upon reorganization, then the manager has an incentive to favor reorganization over liquidation, regardless of affect on firm value. Compensating a manager with a percentage of assets in a liquidation, creates an incentive to favor liquidation.[7] Listokin is also concerned about managerial loyalties to pre-petition equity because directors selected by pre-petition equity appointed the managers.[8]

To mitigate these problems, Listokin has proposed compensating management during bankruptcy, at least in part, with a pro-rata percentage of the bankrupt company's existing unsecured pre-petition debt (the "'vertical strip'").[9] To enable such compensation without free-riding, Listokin proposes creating a right for the unsecured creditors' committee to bind all unsecured creditors to grant such compensation (with potential opt-outs for senior unsecured creditors and a matching vertical strip of equity from the equity holders committee).[10] Listokin believes debt compensation would incentivize managers to maximize the firm's value, be it through reorganization or liq-

---

nancing, 46 VAND. L. REV. 901, 901-04 (1993) (same); *see also* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 787-96 (1993) (proposing shortening the length of bankruptcy proceedings and providing risk compensation premiums to risk-adverse creditors to encourage value maximization).

[4] The notable exception being Skeel, *supra* note 3, at 948-49.

[5] Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV 777 (2007).

[6] An issue Listokin does not address and which lies beyond the scope of this Response is whether and how to account for social externalities in corporate reorganizations.

[7] Listokin, *supra* note 5, at *781-82*.

[8] *Id.* at 784.

[9] *Id.* at 783.

[10] *Id.* at 785-86.

uidation. He argues that unsecured debtholders "are the most common residual claimants in bankruptcy," so they are the real parties-in-interest in a bankruptcy because they are the ones affected by marginal changes in the debtor's value.[11] Compensating managers with unsecured debt would encourage them to "self-interestedly pursue actions that benefit the creditors" as residual claimants.[12]

By emphasizing the issue of management compensation and providing astute and detailed analyses of incentive structures in various compensation systems, Listokin has advanced the debate on corporate governance in bankruptcy in an important way. Nonetheless, I am skeptical about his proposal because I fear its costs likely outweigh its benefits.

My main issue with Listokin's proposal is its highly stylized understanding of the interactions, knowledge, and incentives of the parties in a bankruptcy. Listokin's proposal is based on a model of a firm with three classes of claimants, each of a different priority level (secured, unsecured, and equity).[13] The firm's liquidation value is known, but its reorganization value depends on managerial performance.[14]

Actual Chapter 11 cases are more complex. There are frequently more priority levels and multiple classes within each priority level. Neither liquidation nor reorganization values are known with precision. Management does not have a leading role in the reorganization process, and firm value is often unrelated to managerial performance. These complexities could result in debt compensation exacerbating agency costs.

Three specific problems stem from Listokin's model. First and foremost, it leads him to believe a residual owner can be identified ex ante and creditors' committees can craft efficient debt compensation packages. Realistically, though, as empirical studies have shown, it is often impossible to identify the residual owner ex ante, so debt compensation could easily misalign incentives and raise agency costs. Second, Listokin does not account for bankruptcy's robust existing system of corporate governance, which limits the marginal benefits of his proposal. Finally, Listokin does not consider the significant systemic

---

[11] *Id.* at 783.

[12] *Id.* at 810.

[13] *Id.* at 787. Listokin relaxes some of the model's assumptions, such as the number of priority levels and alignment of interests of creditors of same priority. *Id.* at 812, 818-19.

[14] *Id.* at 787.

costs of his proposal, which would require both a radical transformation of the role of creditors' committees in bankruptcies and the substantive consolidation of debtors. These changes would undermine the creditor/shareholder distinction at the core of corporate finance. In light of the empirical faults in the foundation of Listokin's proposal, the adequacy of the existing system, and the proposal's systemic costs, I am unconvinced debt compensation would meaningfully improve corporate governance in bankruptcy and worry that it might be deleterious.

I. UNWARRANTED ASSUMPTIONS

Listokin seeks to align managerial incentives with the interests of the residual creditors because they are the ones who are affected by the marginal change in company value as a result of managerial decisions. This solution evinces many of the problems endemic to economic analyses of bankruptcy law, namely that it is based on a set of assumptions that are either debatable or contrary to empirical evidence. Listokin generally assumes a capital structure with one priority level of unsecured creditors,[15] who have aligned interests and are the likely residual claimants on the bankruptcy estate.[16] Listokin further assumes the residual claimants possess the information necessary to make proper compensation decisions.

When Listokin's assumptions are changed to reflect actual Chapter 11 conditions, however, we see that debt compensation schemes can easily misalign managerial incentives and result in overcompensating managers who do not increase a firm's value. As Lynn LoPucki has noted, if we suspend either the assumption that a firm's residual owner is obvious or that the firm's value is known, "the residual owner theory of corporate governance collapses."[17]

A. *That It Is Possible To Identify the Residual Owner Ex Ante*

Capital structures of large corporations are more complex than in Listokin's model.[18] Lynn LoPucki has shown that "[t]he typical reorganizing firm has about four investor priority levels that are subordi-

---

[15] *Id.* at 787.

[16] *Id.* at 783.

[17] Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341, 1342 (2004).

[18] In particular, junior unsecured debt is oddly absent from Listokin's analysis.

nate to secured and bankruptcy priority creditors."[19] This leads to two problems.

First, "[t]he existence of so many investor priority levels makes it likely that investors at more than one level will share residual owner status."[20] LoPucki has demonstrated that no identifiable, single residual owner class exists in most reorganizing large public companies. "[I]n 62% of the firms studied, the reorganization plan recognized that investors at more than one priority level shared residual owner status in a manner that left them with a substantial conflict with respect to investment policy."[21] The residual claimants cannot be reliably identified ex ante, when the compensation decision is made, so we cannot know the party with whom managerial incentives should be aligned.

Second, the existence of multiple priority levels makes conflicts of interest among unsecured creditors (and equity) likely. Separate classes within priority levels also have divergent interests. It is thus futile to attempt to align the incentives of managers with those of the residual owners, even if the residual owners could be identified ex ante, because different owners' interests can be at cross-purposes. Whose interests should management advance? Listokin acknowledges that not all unsecured creditors will favor debt compensation and may even be harmed by it,[22] but downplays the significance of conflicting interests among unsecureds:

> [T]he fact that some groups of creditors are harmed by debt compensation is not reason to doubt its usefulness. Bankruptcy procedures strive to obtain the greatest value from the bankrupt firm, not to satisfy any particular group of creditors. If debt compensation maximizes value while harming one group of creditors, then it adds value and should still be encouraged.[23]

Listokin's response to the problem of conflicts among unsecured creditors is a normative—not positive—description of bankruptcy law. Bankruptcy law is replete with special interest protections unrelated to value maximization.[24]

---

[19] LoPucki, *supra* note 17, at 1343.
[20] *Id.*
[21] *Id.*
[22] Listokin, *supra* note 5, at 815.
[23] *Id.* at 816.
[24] *See, e.g.*, 11 U.S.C. § 365(b)(3) (2000), *amended by* Pub. L. No. 109-8, 119 Stat. 23 (2005), (providing special protections for shopping center landlords); *id.* § 365(h)(2)(A) (providing special protections for timeshares); *id.* § 365(n) (providing special protections for intellectual property licensors); *id.* § 366 (providing special pro-

B. That Creditors' Committees Have Adequate Information To Make Efficient Compensation Agreements

Listokin's proposal depends on the creditors' committee possessing sufficiently certain information to make an efficient compensation decision. Listokin assumes that at the time of the compensation decision, the creditors' committee knows the liquidation and reorganization values of the firm and the manager's idiosyncratic valuation of these options. Also implicit in Listokin's analysis is that these values are fixed throughout the bankruptcy. Absent any of these assumptions, however, debt compensation might actually skew managerial incentives toward *minimizing* firm value.

Liquidation and reorganization values can seldom be determined with any precision, and certainly not at the outset of a case. Debtors are required to file schedules of all their assets and liabilities at the beginning of a bankruptcy,[25] but these are estimates, not market values. Moreover, different creditors often have different valuations. "Differences of 10% are almost inevitable, and often the differences are far larger . . . . Disparities in investors' views over how to value the enterprise and how the judge will value it drive much of the bargaining in large business reorganization cases."[26] Thus, "practitioners have long identified [valuation] as the principal challenge to resolving corporate reorganizations."[27]

Further, many assets and liabilities are contingent, such as litigation claims. Others, like hedging contracts, fluctuate in value for reasons beyond the debtor's control. For example, the value of an airline debtor's fuel hedging contracts depends on the oil market. Fraud allegations cast doubt on all books and records. And what is one to do with a case like that of auto parts manufacturer, Dana Corporation? When Dana filed for bankruptcy, it listed $6.8 billion in liabilities and $7.9 billion in assets.[28] Over the following ten months, creditors filed

---

tections for utility companies); *id.* § 506 (recognizing secured claims); *id.* § 507 (giving priority status to a variety of creditors); *id.* §§ 555-556, 559-562 (providing, *inter alia*, special protections for securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements, and master netting agreements).

[25] FED. R. BANKR. P. 1007(b)-(c).

[26] Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1942-44 (2006).

[27] *Id.* at 1970.

[28] Joseph Rebello, *Dana Says It Faces $25.3 Billion in Claims from Its Creditors*, DOW JONES DAILY BANKR. REV., Oct. 27, 2006, at 2.

claims totaling $25.3 billion.[29] The valuation information available to creditors at the beginning of Dana's bankruptcy could be off by $18.5 *billion*. If so, Dana would be hopelessly insolvent, rather than having sufficient assets to satisfy its pre-petition debt. The efficiency of liquidating or reorganizing depends on valuation accuracy.

Precise liquidation and reorganization values are *never* known with certitude ex ante. Even estimates are often unavailable until well into a bankruptcy, after management compensation agreements have been reached. Nor can one know managers' idiosyncratic valuations (which can themselves fluctuate). Thus, a committee might not award enough debt compensation to properly align management's incentives or it might wastefully award too much.[30] Creditors' committees cannot know the information necessary to properly align incentives in a debt compensation scheme, so Listokin's proposal could exacerbate agency costs and misalign incentives.

II. THE EXISTING LEVERS OF CORPORATE GOVERNANCE IN BANKRUPTCY ARE ADEQUATE

Even accepting Listokin's assumptions, I am still dubious of his proposal because its limited marginal benefits have a high systemic cost. Listokin does not propose replacing sticks with carrots so much as he proposes a costly carrot to supplement a stick regime that he has

---

[29] *Id.*

[30] To illustrate, consider Listokin's example of how, absent debt compensation, a manager might make an inefficient choice between reorganization and liquidation. Listokin, *supra* note 5, at 801-03. A firm has $10 million in secured debt and $50 million in unsecured debt. The firm's assets are worth $20 million in liquidation, but only $15 million in reorganization. Thus, the unsecured creditors' return in a liquidation is $5 million more than in reorganization. Liquidation is more efficient, but the manager also values continued employment with the firm (a possibility only with a reorganization) at $100,000. Therefore, if paid a fixed salary during the bankruptcy, the manager has an incentive to reorganize the firm.

If the creditors' committee offers the manager a 3% vertical strip of unsecured debt, however, the manager's compensation choice is between $300,000 in a liquidation (.03*[$20,000,000 - $10,000,000]) or $250,000 in a reorganization (.03*[$15,000,000 - $10,000,000] + $100,000). Accordingly, the manager will choose to liquidate, which is the efficient result. But what if the committee's valuation guesstimates were off and it only offered a 1% vertical strip? The incentives would end up reversed, as the manager would choose between $100,000 for a liquidation (.01*[$20,000,000 - $10,000,000]) or $150,000 for a reorganization (.01*[$15,000,000 - $10,000,000] + $100,000). Or what if the manager's idiosyncratic valuation of a reorganization is or later rises to $200,000? Again, debt compensation (even at 3%) will misalign incentives and at a high cost. The committee can only adjust for uncertainty by erring toward overcompensation, but this direct cost diminishes (and potentially offsets) incentive compensation's benefits.

not shown to be inadequate.

A. Bankruptcy Imposes Safeguards Absent in Normal Business Operations

Corporate governance is more tightly policed in bankruptcy than in normal business operations. Bankruptcy is polyphonic, and management's voice is far less powerful in bankruptcy than in normal business operations.[31] In bankruptcy, management is subject to oversight not just by directors, shareholders, and the SEC; but also by courts, the United States Trustee, and creditors. Management's decisions outside of the ordinary course of business are reviewed by the bankruptcy court.[32] Creditors, equity holders, and the United States Trustee may make objections, and a plan of reorganization, if proposed, is subject to approval by at least two-thirds in amount and more than one-half in number of one class of impaired creditors.[33]

In addition to standard corporate governance tools such as fiduciary duties, debt covenants, and removal of officers and directors, there is a vast arsenal of disciplinary devices available only in bankruptcy: adequate protection orders and lift stay motions, debtor in possession (DIP) financing covenants, objections to retention agreements and fees, motions for appointment of an examiner or trustee, termination of plan exclusivity, and other, more specific statutory protections.[34]

---

[31] *See, e.g.*, Marie Beaudette, *Hedge Funds Turn Chapter 11 Into an Arena for Takeovers*, DOW JONES DAILY BANKR. REV., Dec. 19, 2006, at 2 (noting that the veto power of large creditors, such as hedge funds, can strip a Chapter 11 company's management of control over the process of reorganization).

[32] *See* 11 U.S.C. § 363(b)(1) (2000), *amended by* Pub. L. No. 109-8, 119 Stat. 23 (2005) (authorizing the trustee to "use, sell, or lease" property of the insolvent party to meet obligations); *id.* § 364 (authorizing the trustee to take on debts on behalf of the insolvent party), *id.* § 365 (authorizing the trustee to reject contracts entered into by the insolvent party).

[33] 11 U.S.C. §§ 1126(c), 1129(a)(7)-(8), (10) (2000).

[34] There is also informal regulation of managerial compensation in bankruptcy. For example, the unofficial policy of the United States Trustee for the Second Region is to object to any retention agreement that does not comply with its "Jay Alix Protocol," which requires disclosure of conflicts of interest; limits turnaround companies from serving in multiple capacities to the debtor (the "one hat" policy); limits indemnification of turnaround managers to the terms provided to regular officers and directors; prohibits the turnaround company's affiliates from investing in the reorganized debtor for three years after the case's conclusion; and requires court approval of success fees and other back-end fees on a reasonableness standard at the end of the case. Protocol for Engagement of Jay Alix & Associates and Affiliates (Nov. 3, 2004), *available at* http://www.usdoj.gov/ust/r02/docs/chapt11/manhattan_retention/Jay_Alix_Protocol.doc. The Jay Alix Protocol is not binding, but it has become a *de facto* shibboleth for management compensation in bankruptcy.

Thus, even without incentive compensation, there are stronger levers of corporate governance in bankruptcy than in normal business operations.

B. Managerial Behavior Is Subject to Market Discipline Prospectively

Agency problems are also lessened in bankruptcy by the specialized profession of turnaround managers. When a corporation is in financial trouble, the board, at the insistence of senior creditors, often brings in new turnaround management.[35] Turnaround managers are generally not looking for continued employment with restructured companies; their skill-set lies in crisis management, not quotidian management or industry-specific expertise.[36] This lessens concerns about managers favoring reorganizations to continue employment with the debtor.

The turnaround industry also imposes market discipline on managerial behavior. Regardless of compensation, turnaround managers want to maximize corporate value. A turnaround manager's effectiveness depends on his ability to tap into new sources of funding, which depends, in turn, on the manager's reputation in the creditor community. As repeat players in the bankruptcy business, turnaround managers derive significant reputational value from the results of a bankruptcy, which affects their ability to get future business and the fees they can command prospectively. Accordingly, turnaround managers desire outcomes the market considers a success, which should be equivalent to maximizing the debtor's value. The turnaround industry's reputational incentives subject managerial behavior in bankruptcy to market discipline.

C. The Current Bankruptcy Corporate Governance System Generally Works

Bankruptcy's monitoring and market systems of corporate governance appear to work fairly well. Examples of executives looting their own companies abound outside of bankruptcy, but there is only weak and sporadic evidence of managerial misdeeds in bankruptcy. Listokin does not provide any such examples, and I have been unable to locate reported decisions involving breaches of the duty of loyalty

---

[35] *See* Baird & Bernstein, *supra* note 26, at 1932 ("[O]ld managers frequently are replaced . . . with turnaround specialists. . . .").

[36] *See id.* at 1951 ("The new managers are newly hired turnaround specialists, not entrepreneurs whose firm-specific skills are essential to the business nor well-entrenched owner-managers who exclusively possess valuable private information.").

in bankruptcy cases dealing with compensation-driven management decisions—other than those involving partnership bankruptcies or managers with investments in the debtor unrelated to compensation. This is not to say the current system is perfect, only that corporate governance in bankruptcy appears superior to normal business operations.

Notably, the sole example Listokin provides—that of Enron—illustrates the success of bankruptcy's current system of safeguards. Listokin cites the $1.32 million annual compensation and the $5 million minimum success fee Enron awarded to CEO Stephen Cooper in 2002 as an example of the current deficiencies in management compensation in bankruptcy.[37]

The story does not end there, however. Enron initially proposed the arrangement Listokin describes, but creditors objected to it because, *inter alia*, of the success fee and the excusal of Cooper from fiduciary duties.[38] Enron then revised its retention agreement to eliminate the guaranteed success fee and to clarify that normal fiduciary duties applied to Cooper.[39] The court approved the revised agreement, subject to further cutbacks.[40] Despite the agency problems in the original retention agreement, its revision shows the current monitoring process works.

Bankruptcy already has an effective system of sticks policing

---

[37] Listokin, *supra* note 5, at 797.

[38] *See* Objection of U.S. Sec. & Exch. Comm'n to Motion by Enron Corp. and Its Affiliated Debtors To Enter into an Agreement To Employ Stephen Forbes Cooper as an Independent Contractor at 5, *In re* Enron Corp., No. 01-16034(AJG), 2002 WL 32151495 (Bankr. S.D.N.Y. Mar. 8, 2002) (recording this objection); Objection of the Florida State Board of Administration Debtor's Motion Pursuant to 11 U.S.C. § 363 for an Order Authorizing Debtors To Enter into an Agreement To Employ Stephen Forbes Cooper, LLC as an Independent Contractor To Provide Management Services for the Debtors *Nunc Pro Tunc* to January 30, 2002 at 2, *In re* Enron Corp., No. 01-16034(AJG), 2002 WL 32151494 (Bankr. S.D.N.Y. Mar. 8, 2002) (same).

[39] *See* Notice of (A) Filing of Revised Agreement and (B) Hearing in Connection with Debtors' Order Pursuant to 11 U.S.C. § 363 Authorizing the Debtors To Enter into an Agreement To Employ Stephen Forbes Cooper, LLC as an Independent Contractor To Provide Management Services for the Debtors *Nunc Pro Tunc* to January 30, 2002, Exhibit A at 2, ¶2(b), *In re* Enron Corp., No. 01-16034(AJG), 2002 WL 32151493 (Bankr. S.D.N.Y. Mar. 15, 2002) (recording the revision).

[40] *See* Order Pursuant to 11 U.S.C. § 363 Authorizing the Debtors To Enter into an Agreement To Employ Stephen Forbes Cooper, LLC as an Independent Contractor To Provide Management Services for the Debtors *Nunc Pro Tunc* to January 28, 2002 at *1-2, *In re* Enron Corp., No. 01-16034(AJG), 2002 WL 32150520 (Bankr. S.D.N.Y. Apr. 4, 2002) (requiring Cooper to recuse himself from disputes between debtors and his equity company, and explicitly denying Cooper any specific protection from normal duties).

managerial behavior, and a market system of both sticks and carrots encouraging value maximization by turnaround managers. It is not clear that Listokin's proposed carrot supplement is necessary or that it would offer any improvement. It also comes with significant systemic costs.

III. SYSTEMIC COSTS TO GIVING CREDITORS' COMMITTEES BINDING AUTHORITY

There are both direct and systemic costs to Listokin's proposal. Since it is voluntary, creditors can avoid the direct costs if they do not outweigh the benefits. But the systemic costs are serious and unavoidable. Listokin's proposal would require sweeping changes in the selection and governance of creditors' committees, as well as the consolidation of different debtor entities of the same firm. These actions would blur key distinctions between debt and equity, reduce incentives for individual creditors to monitor the debtor, and unwind carefully considered structural subordination in lending.

A. *Costs of the Altered Nature of Creditors' Committees*

The crucial feature of Listokin's proposal is giving the creditors' committee the right to bind all unsecured creditors. Listokin contends:

> Making the decision of the creditors' committee binding upon all general unsecured creditors is not a radical idea. Shareholders of a company outside of bankruptcy cannot opt out of stock option plans. Instead, the shareholders are bound by the decision of the board of directors. Similarly, general unsecured creditors should be bound by the decisions of the unsecured creditors' committee.[41]

Creditors are not shareholders, however, and a creditors' committee is not a board of directors. Two major considerations in extending value as a creditor rather than as a shareholder are separateness and independence. To be sure, pre-petition creditors often become the shareholders of a reorganized company, and bankruptcy forces all creditors to submit to a form of majority rule in class voting on reorganization plans. But the majority rule is not based on an electorate of all creditors or even of creditors of the same priority level. Rather, creditors vote class by class.[42]

---

[41] Listokin, *supra* note 5, at 816.

[42] 11 U.S.C. § 1126(c) (2000).

Even within the same priority level, different classes of creditors have different rights and interests and are often classified separately: tort plaintiffs with unliquidated claims, suppliers hoping for continued business, undersecured finance creditors, landlords, employees, etc.[43] Should a single creditors' committee be allowed to bind these different parties based on what is best for the estate, when these parties are not even bound together in plan voting? Until there is a reorganization, pre-petition creditors remain creditors, and shareholders remain shareholders.

The only time that creditors are ever subjected to collective treatment like shareholders is as part of a plan of reorganization. Creditors, however, have significant protections in the plan approval process, such as the requirement that a class approve a plan by a supermajority of two-thirds in amount and a majority in number of claims,[44] the best interests test,[45] the good faith requirement,[46] the feasibility requirement,[47] and the absolute priority rule.[48] There are no equivalent protections for creditors vis-à-vis committee decisions.

Currently, creditors' committees have *no* binding authority. They are non-representative, consultative watchdogs, not parliaments of creditors. Creditors' committees are appointed by the United States Trustee at the beginning of the case, and ordinarily consist of the holders of the largest unsecured claims of particular types. Committees are governed according to self-drafted, rather than legislative, bylaws. Were creditors' committees to have binding authority over any issue, the entire process of committee creation and governance would need to be revamped to assure fairness. Committee membership could not remain the bailiwick of the United States Trustee. Dissenting creditors would need safeguards. Listokin does not address the changes to creditors' committees that his proposal requires, but they might engender more problems than the proposal would solve, as they would decrease incentives for individual creditors to monitor the debtor.

---

[43] *See id.* § 1122(a) (providing that only substantially similar claims may be classified together).

[44] *Id.* § 1126(c).

[45] *Id.* § 1129(a)(7).

[46] *Id.* § 1129(a)(3).

[47] *Id.* § 1129(a)(11).

[48] *Id.* § 1129(b)(2).

B. Costs of Necessitating Substantive Consolidation

Listokin's proposal also appears unworkable absent substantive consolidation of debtors. The proposal relies on a single unsecured creditors' committee making a compensation determination that binds all unsecured creditors. In real Chapter 11 bankruptcies, however, absent substantive consolidation, an unsecured creditors' committee might only represent creditors of a particular entity in a corporate structure, not all unsecured creditors of a firm.

Business bankruptcies often involve numerous related companies—parents, subsidiaries, and affiliates—all of which are separate debtors with different assets and liabilities. They also have different creditors (including each other) with different relative priorities and interests. For example, a creditor of a subsidiary has priority over a creditor of the parent vis-à-vis the subsidiary. Therefore, the parent's creditor will want management to take actions that increase the parent's value, rather than the subsidiary's.

Because of this structural subordination, creditors are less concerned with increasing the value of the corporate family than the value of their own particular debtor. If the subsidiary has most of the operating assets, but the parent has most of the debt, the subsidiary's creditors will feel sufficiently confident in their returns that they might think performance pay is unnecessary. The creditors of the parent, on the other hand, would be willing to pay for performance with debt because they have nothing to lose—they are gambling with money already lost.

Although the various debtors' estates are usually jointly administered by the court and run by one management team, they are generally not *substantively* consolidated—that is, their assets and liabilities remain separate. Separate entities' committees might not agree on incentive compensation. If only some entities' committees awarded debt compensation, management's incentives could be skewed toward favoring particular creditor constituencies. The only way to award a vertical strip of all entities' unsecured debt would be to substantively consolidate all the debtor entities (and thus their committees). Forcing substantive consolidation, however, goes against the very nature of structural subordination in lending—creditors lend to one corporate entity and not to another precisely to receive the benefits of separateness.[49]

[49] *See* Robert K. Rasmussen, *The Search for Hercules: Residual Owners, Directors, and Corporate Governance in Chapter 11*, 82 WASH. U. L.Q. 1445, 1448 (2004) ("[S]ubstantive

IV. WHERE DO WE GO FROM HERE?

From a cost-benefit perspective, I am dubious of Listokin's proposal.[50] I am nonetheless optimistic it will advance the scholarly agenda by encouraging empirical research on executive compensation in bankruptcy. Such research should probably begin with an analysis of the terms of retention agreements for professionals in bankruptcy. LoPucki and Whitford's 1993 study is a starting point, but the study's anthropological nature dilutes the strength of its findings,[51] and there have been significant developments in executive compensation in the past decade and a half. Despite my reservations with Listokin's proposal, I am optimistic it will set the stage for empirical research on executive compensation in bankruptcy that will help compensate for the most serious problem facing any corporate governance proposal in bankruptcy: the uncertainties of valuation and hence of the incentives and identity of the residual owner.

consolidation, which has the effect of undoing structural priority, can be threatened by those who would see the value of their holdings increased by lumping all assets and all claims in one pot.").

[50] Listokin's proposal could be implemented with lower costs simply by making consideration of debt compensation part of the fiduciary duties of the debtor's board.

[51] *See* LoPucki & Whitford, *supra* note 3, at 721-22, 750 (acknowledging the subjective nature of their research).