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Paying for Performance in Bankruptcy:  
Why CEOs Should be Compensated  
with Debt

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# **Paying for Performance in Bankruptcy: Why CEOs Should be Compensated with Debt**

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I.	Introduction.....	4
II.	An Example of a Hypothetical Firm in Bankruptcy .....	13
III.	Existing Managerial Compensation Arrangements in Bankruptcy .....	14
	A. Debtor-in-Possession Financing .....	15
	B. Managerial Compensation .....	17
	1. Pay-to-Stay Bonuses .....	17
	2. Rapid Reorganization Bonuses .....	18
	3. Percentage of Assets Compensation Plans .....	19
	4. Percentage of Equity Compensation Plans .....	22
	C. Enron as an Example of the Deficiencies of Current Methods of CEO Compensation in Bankruptcy.....	25
IV.	Debt Compensation for Managers .....	28
	A. Unsecured Creditors and Chapter 11 Bankruptcies .....	28
	B. Debt Compensation for Managers .....	30
	C. Why Debt compensation is an Improvement Upon Existing Means of Managerial Compensation in Bankruptcy.....	34
	1. Improvement Over Pay-to-Stay Bonuses.....	34
	2. Improvement over Rapid Reorganization Bonuses .....	35
	3. Improvement Upon Percentage of Asset Plans.....	36
	4. Improvement Over Equity Compensation Plans.....	40
	5. Improvement of the Functioning of the Creditors' Committee .....	42
	V. Weaknesses of Debt Compensation and Potential Responses .....	43
	A. Debt Compensation's Expense .....	44
	1. Opt-Out for Senior Unsecured Creditors .....	45
	2. Debt Compensation is a Voluntary Plan.....	48
	B. Conflicts Between Creditors Caused by Debt Compensation .....	49
	1. Conflicts Among General Unsecured Creditors .....	50
	2. Conflicts Between Secured Creditors and Unsecured Creditors .....	51
	3. Conflicts Between Senior Unsecured Creditors and General Unsecured Creditors.....	56
	4. Conflicts Between Equity and Unsecured Creditors .....	57
	C. Joint Administration.....	58
	D. Manager has Debt in Reorganized Company .....	60
	1. Problems With Debt-Holding by Managers .....	60
	2. Responses to These Concerns.....	62
	3. Possible Modifications to Debt Compensation.....	64
	E. Change in Prebankruptcy Incentives .....	65
	1. Debt Compensation's Impact on the Propensity to File .....	65
	2. Debt Compensation's Impact on Manager's Treatment of Creditors Before Bankruptcy .....	67
	F. Cautious Implementation Should Prevent the Worst Abuses of Debt Compensation .....	69
VI.	Conclusion .....	71

**Abstract:**

While managerial performance always plays a critical role in determining firm performance, a manager's importance assumes a heightened role in bankruptcy. A manager in bankruptcy both runs the firm and helps form a plan of reorganization. In light of this critical role, one would expect that bankruptcy scholarship would place considerable emphasis on the role of CEO compensation in incentivizing managerial performance in bankruptcy. The opposite is true, however. Bankruptcy scholars and practitioners tend to emphasize other levers of corporate governance, such as the role of Debtor-in-Possession financiers, rather than the importance of CEO compensation. This Article seeks to revive CEO compensation as an important governance lever in bankruptcy. First, the Article examines current ideas and practices of managerial compensation in bankruptcy and finds them wanting. The Article next proposes a novel bankruptcy compensation plan – debt compensation—that provides better incentives for managers to perform efficiently. By granting managers a fixed proportion of unsecured debt in the bankrupt firm, debt compensation creates value-enhancing incentives similar to the incentives created by the stock grants and stock options that are heavily employed by solvent firms to compensate managers.

## I. Introduction

While managerial performance always plays a critical role in determining firm performance, a manager's importance assumes a heightened role in bankruptcy. In bankruptcy, the manager in control of the debtor-in-possession makes all the decisions that the manager of an ordinary firm must make regarding firm operations and strategy. The manager's role does not end there, however. Instead, the manager also plays a critical role in forming a plan of reorganization or liquidation. This task involves many roles, including weighing the choice of liquidation versus reorganization, mediating between different classes of creditors, and selecting the optimal capital structure for the reorganized firm.

How unfortunate, then, that managerial compensation in bankruptcy is so restricted. While managers of ordinary firms receive a wide array of incentive-compensation devices, compensation for a manager in bankruptcy is far more ineffectual and limited.<sup>1</sup> In addition, managerial interests tend to be "closely aligned with the shareholders,"<sup>2</sup> making it unlikely that a manager will design a reorganization plan that maximizes value for the creditors of an insolvent firm. The limitations of executive compensation in bankruptcy are echoed by the lack of scholarly attention to the subject. While the question of executive compensation is the subject of a vast literature in both

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<sup>1</sup> See e.g., DOUGLAS BAIRD, ELEMENTS OF BANKRUPTCY 183 (3<sup>rd</sup> ed. 2001) (stating that "the usual checks that keep the managers of the firm in line—the prospects of profits from their equity interests ... are displaced once a bankruptcy petition is filed").

finance and law,<sup>3</sup> analyses of corporate governance in bankruptcy tend to give the subject short shrift.<sup>4</sup> In an important exception to the pattern of downplaying the role of executive compensation in bankruptcy, Professor David Skeel details some managerial compensation schemes that are prevalent in bankruptcy.<sup>5</sup> These include “pay-to-stay” agreements to retain key managers in the wake of a bankruptcy declaration,<sup>6</sup> and managerial bonuses for speedy reorganization. In addition, Professor Skeel also mentions some proposals for improving these compensation schemes. Skeel states that the ideal solution would be to “base the managers’ pay on the overall value of the debtor’s assets at the conclusion of the Chapter 11 case.” Skeel explains that because of uncertainties regarding valuation, however, this solution will only be attainable when firm value is reasonably well established, such as in liquidation. Instead, Skeel proposes

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<sup>2</sup> See BAIRD, *supra* note 1, at 182.

<sup>3</sup> See, e.g., LUCIAN ARYE BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) and the many references to both finance and legal literatures therein.

<sup>4</sup> See, e.g., Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation For Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425, 457 (2006) (stating that “DIP financing is now the most important governance lever in Chapter 11” and remaining silent on the topic of executive compensation); Douglas G. Baird & Robert K. Rasmussen, *Private Debt And The Missing Lever Of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211 n.4 (2006) (emphasizing the role of creditor monitoring in bankruptcy and contrasting that with the emphasis on matters of executive compensation outside of bankruptcy); Douglas G. Baird and Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003) (arguing that creditors enjoy undue power in bankruptcy). An important exception to this trend is David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003) which is discussed in detail *infra*.

<sup>5</sup> See Skeel, *supra* note 4. Even this article, however, pays more attention to DIP financing than to executive compensation.

<sup>6</sup> The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) sharply limits the use of pay-to-stay agreements. See 11 U.S.C. § 503(c)(1) (providing that the debtor shall not make payments to insiders such as executives for the purpose of inducing such person to remain with the debtor's business" without an express finding by the court that 1. The payment or obligation is essential to keep the person from accepting a bona fide job offer for the same or greater pay; 2. The person's continued retention is essential to the survival of the business; and 3. The amount of payment to made or obligation to be incurred does not exceed either 10 times the amounts paid to non-management employees in the same calendar year or 25 percent of the amounts paid to insiders in the calendar year preceding that in which the payment is to be made, as described by Jason Brookner, *Law Limits Executive Compensation*, May/June EXECUTIVE LEGAL ADVISOR (2006)).

granting stock in the reorganized company to managers. In this way, managers will have incentives to maximize value.

Unfortunately, pay-to-stay agreements, rapid reorganization bonuses, and the Skeel proposals all contain significant flaws. Pay-to-stay agreements may enable the debtor to retain key managerial personnel, but they do nothing to ensure that a manager attempts to maximize value. Rapid reorganization bonuses incentivize a speedy reorganization, not a value-maximizing one. Granting a manager a percentage of liquidation proceeds works well if liquidation is the obvious choice. When liquidation is not the efficient option, however, the prospect of a percentage of the asset return in liquidation may encourage a manager to push for liquidation even when reorganization creates more value. Finally, granting stock in the reorganized company skews managerial incentives in a number of ways. First, it may encourage a manager to prefer reorganization when liquidation is a more efficient option. Second, owning stock in the reorganized company means that a manager has an incentive to insure that the equity of the reorganized company is of the utmost value. This encourages a manager to propose reorganization plans wherein the reorganized company has little or no debt, even if the company has a higher total valuation with some debt in its capital structure.<sup>7</sup>

All of these problems stem (at least in part) from a fundamental difficulty of granting incentive compensation in bankruptcy as compared to incentive compensation in an ordinary firm. In an ordinary solvent firm, a manager's fiduciary duty is associated

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<sup>7</sup> If the Modigliani-Miller theorem applies, then this concern is not relevant. Modern corporate finance has identified several reasons why the theorem does not apply in most cases, including tax consideration and the mitigation of principal-agent problems. The wide variety of capital structures witnessed amongst public corporations suggests that capital structure matters, in spite of the Modigliani-Miller theorem. See MARK GRINBLATT & SHERIDAN TITMAN, FINANCIAL MARKETS AND CORPORATE STRATEGY Part IV (2d ed. 2001).

with the residual claimants—the equity holders.<sup>8</sup> As a result, equity-based incentive compensation plans, such as stock options, are relatively easy to adopt.<sup>9</sup> By granting equity to the manager, incentive compensation aligns managerial incentives with those of the equity residual claimants—when the residual claimants benefit, so does the manager. The manager’s pecuniary incentives accord with her fiduciary duties. In bankruptcy, by contrast the residual claimants (and the manager’s fiduciary responsibilities)<sup>10</sup> are harder to identify. Most frequently, the residual claimants, and those owed fiduciary obligations, are unsecured creditors.<sup>11</sup> In response, the executive compensation proposals described above utilize some proxy for residual claimants when awarding compensation. This process is subject to errors. For example, granting the manager equity in the reorganized firm works well if the residual claimants in bankruptcy also will hold equity in the reorganized firm. If some of the residual claimants in bankruptcy hold debt in the

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<sup>8</sup> Most suits for breach of fiduciary duty are brought by equity shareholders. *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (concerning a class action suit brought by shareholders against corporate directors for breach of the duty of care),

<sup>9</sup> Equity-based compensation plans have themselves come under attack over the last few years. This is because the plans seldom provide the incentives that they are intended for. Instead, they often serve as a vehicle for manager’s to extract rents from the corporation. *See* Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction*, 69 U. CHI. L. REV. 751 (2002).

<sup>10</sup> To be precise, fiduciary responsibilities are owed to the corporation rather than a group of claimants. In reality, fiduciary duties will typically be associated with a group of claimants against the firm because of the difficulty of determining fiduciary duties to an abstract entity such as the corporation.

<sup>11</sup> Courts have implicitly recognized that creditors are common residual claimants by maintaining that corporate officers of insolvent companies have fiduciary duties to creditors. *See, e.g.,* Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787-90 (Del. Ch. 1992); Crédit Lyonnais Bank Nederland, N.V. v. Pathé Communications Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991); *In re* STN Enters., 779 F.2d 901, 904 (2d Cir. 1985); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981); FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983); Official Comm. of Unsecured Creditors of Buckhead America Corp. v. Reliance Capital Group, Inc. (*In re* Buckhead America Corp.), 178 B.R. 956, 968 (D. Del. 1994); Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int’l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass. 1997) (interpreting Delaware law); Thomas Kernaghan & Co. v. Global Intellicom, Inc., No. 90-Civ-3005, 2000 U.S. Dist. LEXIS 6650 (S.D.N.Y. May 17, 2000) (holding that under New York law a bondholder is owed a fiduciary duty by directors and officers of an insolvent corporation).

reorganized entity, however, then there may be a conflict of interest between the manager and the residual claimants.<sup>12</sup>

To remedy these defects and reorient the scholarly debate in bankruptcy towards the problem of executive compensation rather than focusing almost exclusively on other means of corporate governance, this Article proposes a novel form of managerial incentive compensation plan in bankruptcy. The unsecured creditors' committee should be granted a new (conditional) right—the right to grant the manager a percentage of the unsecured debt (a “vertical strip” of unsecured debt) currently held by the creditors of the firm.<sup>13</sup> This right, however, will be subject to several conditions, as described below. Because unsecured creditors are the most common residual claimants in bankruptcy,<sup>14</sup> this right will enable the residual claimants to align the incentives of the manager with their own. When the value of a bankrupt firm rises, it is typically the unsecured creditors who obtain the greatest benefit because the unsecured creditors are the most common residual claimants. Granting a manager debt in the bankrupt firm allows the creditors to

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<sup>12</sup> Even when unsecured creditors hold debt in the reorganized firm, the debt that unsecured creditors receive in the reorganized firm is often worth less than the face value of the debt that these creditors held in the bankrupt firm, indicating that the unsecured creditors are the residual claimants, in spite of the fact that they never hold equity.

<sup>13</sup> Throughout this Article, I will refer to this proposal as “debt compensation.”

<sup>14</sup> In a recent empirical survey of bankruptcies, unsecured creditors proved to be the residual claimants in over half the of Chapter 11 bankruptcies. See Arturo Bris et. al., *The Costs of Bankruptcy: Chapter 7 Cash Auctions vs. Chapter 11 Bargaining*, <http://ssrn.com/abstract=523562> Tbl. 8 (2004). Equity (which shares many similarities to unsecured creditors in bankruptcy and can also join the debt compensation scheme as described below) was the residual claimant in another quarter of Chapter 11s. *Id.* Thus, secured creditors (who are not eligible for the scheme) obtain full recovery in a large majority of Chapter 11s. Moreover, the Bris et. al. figures appear to understate the extent to which “unsecured creditors” in the legal sense are the residual claimants because they apparently report the nominal value of secured debt as the size of the secured claim. See *id.* at 4-6 (discussing how repossessions of secured debt are accounted for in the data and making no indication that the value of secured claims is adjusted to account for the actual value of the secured asset. According to bankruptcy law, if the value of a secured creditor's debt claim against the firm exceeds the value of the security, then the creditor's secured claim is only equal to the value of the security. The rest of the creditor's claim is considered unsecured. See Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931 (1985). Thus, the Bris et. al. figures, which treat a secured creditor's entire debt claim as secured, overstate the amount of secured debt

share these gains with the manager and insures that the manager has the appropriate incentive to pursue these gains.

Granting the manager a percentage of unsecured debt solves many of the inefficient incentive problems generated by the plans described above. If a rapid reorganization increases the total value of the firm and thereby the total recovery for unsecured debt, then a manager receiving a percentage of this debt will have a greater incentive to reorganize rapidly because a rapid reorganization increases the value of the manager's own debt. If a rapid reorganization destroys value, however, then the manager will avoid this choice, unlike a manager receiving a rapid reorganization bonus.

Similarly a manager receiving a percentage of unsecured debt has no incentive to inefficiently favor reorganization or liquidation. If liquidation is the efficient choice, then this will be reflected in an increase in the value of unsecured debt. Because the manager receives a percentage of this increase in value, the manager will have an incentive to choose efficient liquidation. Finally, debt compensation protects against the tendency of the manager to favor equity in bankruptcy. When the manager of a bankrupt company is the same as the pre-bankruptcy manager, the manager will have many ties to equity, which used to control the firm. For example, the manager may have received grants of stock or stock options before the company became bankrupt, giving the manager a direct incentive to favor equity. Debt compensation protects against the manager's inclination to favor equity by giving the manager a direct financial incentive in the performance of debt. If the manager favors equity and in the process destroys value, then the manager

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and therefore understate the frequency with which secured credit gets paid in full (when secured creditors get paid in full, either unsecured creditors or equity become the residual claimants).

receiving debt compensation will experience a financial penalty as the value of unsecured debt will diminish.

Enabling the creditors' committee to grant the manager debt is no panacea. Debt compensation must address several concerns. First, secured creditors may be harmed by the proposal. Debt compensation gives the manager an incentive to raise the value of unsecured debt, possibly at the expense of secured debt. The manager will have an incentive to take potentially value-destroying risks because the upside risk is enjoyed by unsecured creditors (and shared by the manager) while the downside risk is born by the secured creditors (and not shared by the manager).<sup>15</sup> When the value of the firm's assets is near the value of the secured debt claims alone, for example, the likelihood that secured creditors will be hurt by value-destroying managerial risk taking is enhanced. Similarly, an extraordinarily high award of unsecured debt gives the manager greater incentives to favor unsecured creditors at the expense of those who are secured. To mitigate these problems, the bankruptcy judge should deny the unsecured creditors' committee's debt compensation grant under these circumstances.<sup>16</sup>

Debt compensation must be structured to avoid intra-unsecured-creditors conflicts of interest. For example, if the manager owned 1% of some unsecured debt but no percentage of other claims, the manager will have an incentive to favor some classes of unsecured creditors over others when forming a plan of reorganization. To prevent this, the creditors' committee's decision on the size of the debt compensation must bind all

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<sup>15</sup> This problem resembles the "asset substitution problem" that is commonly discussed in corporate law and finance, in which the interests of debt and equity are at odds. See GRINBLATT & TITMAN, *supra* note 7, at 569.

<sup>16</sup> Alternatively, judges can approve an unsecured debt compensation structure on condition that the unsecured creditors make good any loss to the secured creditors.

unsecured creditors. Such a “vertical strip” approach means that the manager potentially holds unsecured debt with many different priority levels, but a constant percentage of each type of debt. This creates a level playing field amongst unsecured creditors. While some unsecured creditors may object to the loss of some percentage of their claims, this will be no different than many other actions taken by the creditors’ committee that have the potential to diminish the value of some creditors’ claims. As a result, the binding nature of the creditors’ committee decision should not be problematic.

Alternatively, the proposal could be modified to allow the most senior unsecured creditors to opt-out of awarding debt compensation. If senior unsecured creditors are extremely confident of receiving their money in any case, then they may see no need to spend money compensating the manager. Consequently, the debt compensation proposal could be modified to allow an opt-out for senior unsecured creditors. The opt-out would reduce the cost of the proposal. While the opt-out may provide incentives for a manager to favor junior unsecured creditors over senior unsecured creditors, senior unsecured creditors will have the ability to weigh this concern when determining whether or not to opt-out.

Equity may also be concerned about debt compensation. Debt compensation gives the manager the incentive to favor unsecured creditors over equity. In some cases, this gives the manager the incentive to be overly cautious. To prevent this problem, equity should be entitled to match the percentage compensation award given by the creditors’ committee. This will ensure that equity is not disfavored with respect to unsecured debt by the manager.

Finally, the cost of the proposal may be a concern. Debt compensation may increase the salaries of managers in bankruptcy. Because the creditors' committee chooses whether or not to award debt compensation, however, the cost of debt compensation should not be a strong concern. Unlike ordinary boards, the manager is unlikely to control a creditors' committee. If the committee chooses to award debt compensation, then this provides strong evidence that the committee believes that debt compensation is worth the cost. If the committee does not believe the debt is worth the cost, then the committee will not award a debt compensation grant.

Thus, a creditors' committee right to grant debt compensation offers a new means to improve managerial performance in bankruptcy. In spite of a number of concerns about the proposal, the proposal should be viable if adopted as described here. Moreover, the proposal can be adopted conservatively at first, with most debt compensation proposals rejected. As judges grow more familiar with the debt compensation procedure, the size and prevalence of the debt compensation awards, and their positive effects on managerial performance in bankruptcy, can grow.

This Article proceeds as follows. Part II outlines an example that will be used to illustrate many of the points developed in this paper. Part III examines existing managerial compensation schemes in bankruptcy and discusses their flaws in greater detail. Part IV details the debt compensation proposal and examines how the proposal addresses many of the flaws of the existing compensations schemes described in Part III. Part V discusses possible objections to the debt compensation proposal and details how the proposals can be modified to account for these concerns. Part VI concludes.

## II. An Example of a Hypothetical Firm in Bankruptcy

Many of the proposals and critiques in this Article are best developed through an example. In order to maintain continuity, this Part outlines the basic framework of the example. As the Article continues, many aspects of the example will be modified to illustrate particular points.

Suppose that a firm (“Firm”) declares bankruptcy. Suppose further that:

Assumption 1: Firm has three classes of claimants. Secured claimants, who are owed \$10 million, unsecured creditors (all of equal priority), who are owed \$50 million,<sup>17</sup> and equity claimants.

Assumption 2: If Firm liquidates, it will raise \$20 million.

Assumption 3: The value of Firm if it reorganizes is more uncertain and depends upon the manager’s (“Manager”) actions. The exact relationship between managerial effort and value will be developed in greater detail in later sections of the Article.

Assumption 4: Manager generally acts to maximize salary. Manager tends to favor equity because Manager owns equity (e.g., restricted stock grants and stock options, as well as ordinary stock) and has a longstanding fiduciary relationship with stockholders.

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<sup>17</sup> The assumption that there is only one class of unsecured creditors is not far-fetched. Section 1122(a) of the Bankruptcy Code provides that all “substantially similar” creditors should be placed in the same class of creditors. 11 U.S.C. § 1122(a). Because all unsecured claimants have the same rights outside bankruptcy, there is a reasonable argument that all unsecured claimants should be in the same class. *See Granada Wines, Inc. v. New England Teamsters & Trucking Indus. Pension Fund*, 748 F.2d 42, 46 (1<sup>st</sup> Cir. 1984); BAIRD, *supra* note 1.

### III. Existing Managerial Compensation Arrangements in Bankruptcy

Managers have two jobs in bankruptcy. First, they run the corporation, just as ordinary managers do. In addition, they form a plan of reorganization or liquidation.<sup>18</sup> This typically involves a fundamental reshuffling of the firm's capital structure, as well as new agreements with other firm stakeholders such as employees and lessors. The manager's<sup>19</sup> role is therefore particularly important in bankruptcy, and has critical implications for all claimants on the bankrupt firm.

Chapter 11 of the 1978 Bankruptcy Code grants considerable powers to the manager of a firm declaring bankruptcy. For example, Chapter 11 authorizes managers to operate the firm as "debtors-in-possession" and grants managers a window during which they have the exclusive right to propose a plan of reorganization.<sup>20</sup> The Bankruptcy Code thereby combines considerable managerial powers with limited managerial controls, a recipe for trouble. It should not be surprising, then, that managerial performance in the early days of the Bankruptcy Code was poor. As Professor Skeel stated, "managers were playing with creditors' money."<sup>21</sup>

Luckily, the bankruptcy system has confronted some of these problems. In his survey article, Professor Skeel describes several corporate governance techniques

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<sup>18</sup> See 11 U.S.C. § 1121(b), granting the debtor an exclusive right to develop a plan of reorganization for 120 days.

<sup>19</sup> Throughout the Article, I will use the singular term "manager". Management, of course, often consists of several individuals. All the points made in the paper, however, apply equally well to the case of a management team as they do to a single manager.

<sup>20</sup> See 11 U.S.C. § 1121(b). See DAVID SKEEL, *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 160-83, 212-37 (2001) for a detailed discussion of corporate governance in Chapter 11.

<sup>21</sup> Skeel, *supra* note 4, at 920.

currently in use as well as a number of new proposals. Some of these methods, such as debtor-in-possession financing, control the manager's behavior indirectly, while other, such as rapid-reorganization bonuses, give the manager direct incentives to behave in certain ways. While all of these methods constitute important improvements with respect to the early Chapter 11 practices, they all retain some critical flaws.

### ***A. Debtor-in-Possession Financing***

Debtor-in-possession (DIP) financing allows some creditors to obtain considerable leverage over a debtor-in-possession. DIP financing works as follows. Under Section 364 of the Bankruptcy Code, creditors who provide financing to debtors in bankruptcy enjoy many enhanced rights (subject to court approval), such as priority with respect to all secured and unsecured loans and administrative expenses. When a debtor needs cash to continue operations, a prospective DIP lender can make numerous demands of the debtor. These demands may include a change in management or seats on the debtor's board of directors.<sup>22</sup> Thus, if a manager will need DIP financing, the manager's behavior is constrained by the prospect that the DIP lender will demand a change in management if the manager's performance is weak.

DIP financing provides a useful check on managerial behavior. However, DIP financing does not come close to providing a comprehensive solution to the problem of managerial performance in bankruptcy.<sup>23</sup> First, DIP financing comes with its own flaws,

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<sup>22</sup> Skeel, *supra* note 4, at 931-32.

<sup>23</sup> Large DIP lenders include J.P. Morgan and GE Capital, which were both involved in making multi-billion dollar DIP loans to WorldCom and Kmart. See Daniel Gross, *WorldCom Is Bankrupt; So How Did It Get a \$2 Billion Loan*, SLATE (July 24, 2002), <http://www.slate.com/id/2068443/>.

such as the possibility of overinvestment.<sup>24</sup> Second, not all debtors need DIP financing. When the debtor does not require cash to operate,<sup>25</sup> a manager is unlikely to submit to the requirements of DIP lenders. Third, DIP lenders are not ideal monitors of managerial performance. Because DIP lenders enjoy enhanced priority, they may not be particularly interested in the firm's performance as they are guaranteed repayment in almost all eventualities. Even if the DIP is not assured of repayment, the DIP will be risk averse because, as a super-secured creditor, it only risks non-payment if the firm's assets fall in value.<sup>26</sup> In either case, the DIP lender is unlikely to pressure the manager to take value maximizing decisions because the DIP lender is not the residual claimant. This tendency will be exacerbated when the DIP lender is already a large creditor of the bankrupt firm.<sup>27</sup> If this is the case, then the DIP lender may favor actions that maximize the value of its other loans, rather than actions that maximize the value of the firm as a whole. Finally, even if the DIP lender replaces the management, someone must run the company. If incentives for the new managers are not appropriate, then DIP financing has altered rather than eliminated the corporate governance problem for firms in bankruptcy.

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<sup>24</sup> The knowledge that DIP financing can be obtained after all assets have already been secured can lead a firm to overinvest in current projects, secure in the knowledge that if a profitable future opportunity arises, the firm will be able to find financing. For a discussion of DIP financing, see generally George Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993).

<sup>25</sup> Debtors in bankruptcy enjoy a stay from loan repayments. Any debtor with positive operating cash flow or significant cash reserves will therefore be able to operate in bankruptcy without the need for DIP lending. Of course, companies with positive cash flow and/or large cash reserves are unlikely to declare bankruptcy. Examples of companies that have declared bankruptcy with positive cash flows and cash reserves includes companies facing large tort liabilities, such as Johns Manville (asbestos liability) or Dow Corning (breast implant liability). For a discussion of these cases, see Yair Listokin & Kenneth Ayotte, *Protecting Future Claimants in Mass Tort Bankruptcies*, 98 N.W. U. L. REV. 1435 (2004); Mark J. Roe, *Bankruptcy and Mass Tort*, 84 COLUM. L. REV. 846 (1984).

<sup>26</sup> See the discussion in Skeel, *supra* note 4, at 935-39.

<sup>27</sup> For a case in which the unsecured creditors' committee objected to the terms of a DIP loan, see Official Committee of Unsecured Creditors of New World Pasta Co. v. New World Pasta Co., 322 B.R. 560 (M.D. Pa. 2005)

## ***B. Managerial Compensation***

Managerial pay-for-performance plans offer the potential for a more direct and comprehensive solution to the managerial incentive problem in bankruptcy. If a manager's pay can be aligned with the value he or she creates or destroys in bankruptcy, then the manager will have a greater incentive to maximize firm value. Rather than depending on managerial goodwill to insure proper behavior, incentive compensation plans rely on managerial self-interest to stimulate good behavior. Unfortunately, designing pay-for-performance plans in bankruptcy is tricky. All of the existing and proposed plans suffer from serious flaws, suggesting an acute need for new proposals in this area.

### **1. Pay-to-Stay Bonuses**

Professor Skeel reviews several pay-for-performance plans. The simplest plan is the "pay-to-stay" bonus.<sup>28</sup> In order to prevent talented personnel from leaving a troubled debtor, some companies offer bonuses to key managers who remain with the company through bankruptcy. In addition to the troubling perceptions generated by granting bonuses to the manager of a newly bankrupt company, pay-to-stay bonuses give a manager no incentives for good performance. If the Manager of Firm received a pay-to-stay bonus, for example, it would have no effect on Manager's incentives to choose liquidation (Assumption 2) as opposed to reorganization (Assumption 3), nor would it have any impact on Manager's incentives to choose the best reorganization plan under Assumption 3. Debtor firms would be better served using the money currently devoted to

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<sup>28</sup> Skeel, *supra* note 4, at 926-28.

pay-to-stay bonuses on pay-for-performance plans. These plans give the manager an incentive to stay while also creating incentives for value-maximizing managerial behavior.

## 2. Rapid Reorganization Bonuses

The most widely used pay-for-performance measure at present is the rapid-reorganization bonus.<sup>29</sup> Under this plan, the manager's compensation is tied to the speed of reorganization; the faster the reorganization, the greater the manager's compensation.<sup>30</sup> When firm value is closely correlated with reorganization speed, the rapid-reorganization bonuses properly align the manager's incentives with those of the residual claimants, who benefit most from a rapid reorganization. In many cases, however, faster reorganizations do not maximize value. If the firm's capital structure was reorganized hastily and ineffectually, for example, then the firm may experience difficulties after it emerges from a rapid reorganization, ultimately hurting the value recouped by creditors. Moreover, the rapid reorganization bonus neglects any incentive for good management during the reorganization of the company. With no reward for effectively operating the company, the manager will focus primarily on a plan of reorganization. The firm's operations may suffer accordingly.

The example outlined in Part II provides an illustration of the dangers of rapid reorganization. Suppose that Manager receives a rapid reorganization bonus, but is otherwise compensated by a flat salary. Assumption 3 of this example provided that the

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<sup>29</sup> Skeel, *supra* note 4, at 927.

<sup>30</sup> The Enron managerial pay proposal included bonuses for selling assets quickly. See Frank Ahrens, Enron Files for New Bonuses, Severance, WASH. POST, Mar 30, 2002, at D13.

reorganization value of Firm depended upon Manager's efforts. Suppose that Manager can choose whether or not to hire consultants who will facilitate the reorganization process. Suppose that the consultants cost \$10 million in fees, and that by speeding the reorganization process, they raise the value of Firm by \$5 million. Efficiency dictates that Manager should not hire the consultants because the consultants cost more than they are worth. With a rapid reorganization bonus, however, Manager would choose to hire the consultants. Manager's salary goes up when reorganization is speedier, but is otherwise independent of Firm's value. As a result, our self-interested Manager would choose to hire the costly consultants.

### **3. Percentage of Assets Compensation Plans**

Professor Skeel recognizes the need for different measures that “more closely link managers' effectiveness to their bankruptcy pay” and discusses some possibilities for meeting this demand.<sup>31</sup> First, he asserts that the best measure of managerial performance is to base managerial compensation on the overall value of the debtor's assets at the conclusion of bankruptcy. Professor Skeel recommends this approach for bankrupt firms that undergo liquidation.

#### **a) Skewed Incentives**

The “percentage of assets” approach, however, fails to offer a general solution to the managerial compensation problem in bankruptcy. As Professor Skeel notes, the percentage of assets approach cannot be used in Chapter 11 reorganizations because of

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<sup>31</sup> Skeel, *supra* note 4, at 948-50.

the difficulty of obtaining an accurate valuation of the debtor's assets at the end of bankruptcy.<sup>32</sup>

The percentage of assets approach suffers from some other flaws not mentioned by Professor Skeel. For example, it encourages managers to unduly favor liquidation over reorganization. Returning to the example developed in Part II, suppose that Manager's compensation scheme calls for Manager to receive 1% of the Firm's assets in the event that Firm is liquidated and that Manager receives salary of \$80,000 in the event of a reorganization. Suppose also that, contrary to initial expectations, Firm will be worth \$15 million in reorganization (recall that Assumption 2 provides that Firm is worth \$10 million in reorganization). Reorganization thus realizes more value than liquidation. Manager, however, prefers liquidation. In liquidation, Manager receives  $.01 * \$10 \text{ million} = \$100,000$ , which is the greater than the \$80,000 salary the manager receives after reorganization. Because of this problem, the percentage of assets approach can only be used when liquidation is unquestionably the preferred option. This severely limits the approach's value.<sup>33</sup>

## **b) Low-Powered Incentives**

The percentage of assets approach also specifies a very "low-powered" and expensive pay-for-performance plan.<sup>34</sup> To see this, modify Assumption 2 to allow

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<sup>32</sup> Skeel, *supra* note 4, at 948. In this respect, it is unlike pay-for-performance schemes (such as stock options) outside of bankruptcy, which are easy to value because they are granted in a form for which the market provides a valuation. The debt compensation proposal described in the next Section helps obtain the tight link between managerial performance and compensation that Skeel seeks without the need to directly value the debtor's assets at the end of bankruptcy.

<sup>33</sup> This example is admittedly contrived. Nevertheless, the fact that it is so easy to develop an example wherein the percentage of assets approach fails suggest that the approach has very limited applicability.

<sup>34</sup> Low powered incentives occur when a manager does not reap a large percentage of the value that her efforts create. For a discussion of low powered incentives in managerial compensation and leveraged buy

Manager's effort to impact the liquidation value of Firm. If Manager performs poorly, Firm is worth \$10 million in liquidation, while if Manager performs well then Firm is worth \$12 million in liquidation. In these circumstances, granting Manager a percentage of the first \$10 million of Firm is wasteful. Firm will be worth at least \$10 million no matter what Manager does, so granting Manager a percentage of the first \$100,000 (assuming Manager still gets 1% of the value of the firm) costs money while generating no incentives for improved performance. Rather than granting a simple percentage of the assets of Firm, a better pay-for-performance plan would grant Manager a percentage of the value of the debtor's assets over \$10 million. In this plan, Manager only receives a bonus if her performance generates value. No money is wasted on paying Manager unnecessarily.

The percentage of assets plan also fails to specify how the costs of CEO compensation should be shared amongst the various creditors of the firm. The secured creditors of Firm will dislike the percentage of assets approach. Because their claims are only \$10 million (Assumption 1) and Firm is guaranteed to be worth that much, secured creditors view the percentage of assets approach as wasteful. Unsecured creditors, by contrast, would favor the percentage of assets approach because it gives Manager an incentive to create additional value that would be used by Firm to pay unsecured creditors. The percentage of assets approach must develop some means of deciding between these two classes of creditors. For all of these reasons, the percentage of assets approach, while intriguing, does not offer a promising pay-for-performance package for managers of bankrupt firms.

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outs, see Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AMER.

## 4. Percentage of Equity Compensation Plans

Professor Skeel next suggests that managers receive a portion of the stock of the reorganized entity. This proposal gives the manager strong incentives to operate the debtor efficiently. The better the firm's operations perform in bankruptcy, the greater the value of the reorganized entity and therefore the greater the value of the manager's portion of equity.

### a) Inefficient Capital Structure

Unfortunately, granting the manager a portion of the equity in the reorganized company provides the manager with poor incentives to restructure the company effectively. Rather than attempting to formulate a reorganization plan and financial structure that maximizes value for the creditors of the bankrupt firm, the manager has an incentive to maximize the value of the equity in the reorganized entity. Thus, the manager's incentives may conflict with the goals of creditors. For example, the manager has an incentive to eliminate as much debt as possible in reorganization.<sup>35</sup> The less debt in the bankrupt company assumed by the reorganized company, the greater the value of the reorganized company's equity. A manager may even threaten to destroy value to induce creditors to cancel more of their claims against the reorganized debtor—clearly inefficient behavior. Relatedly, a manager promised a certain percentage of the equity in a reorganized corporation has no incentive to create a financial structure that maximizes the value of the reorganized entity. Instead the manager will prefer an all equity capital structure, with no debt to dilute the value of her equity rights. This behavior may be

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ECON. REV. 323 (1986).

inefficient. Researchers in corporate finance have identified many advantages to debt as a means of mitigating a wide array of agency problems.<sup>36</sup> If the reorganized firm holds too little debt, agency problems may prove formidable, thereby reducing the total value of the debtor's assets.

The dangers of equity compensation can be highlighted in our example. Suppose that Manager gets 5% of equity in the reorganized Firm. Further suppose that, by mitigating agency problems, a reorganized Firm capital structure that has a debt/equity ratio of 1 to 1 makes Firm worth \$40 million (\$20 million in debt and \$20 million in equity), while an all equity Reorganized Firm is worth \$30 million (\$0 in debt and \$30 million in equity). In this context, efficiency dictates that Manager should choose the debt/equity ratio of 1 to 1 because it realizes more value (\$40 million rather than \$30 million). Manager would choose an all equity capital structure, however, because Manager's return is higher under this structure; 5% of the \$30 million in equity of the all equity reorganized Firm is greater than 5% of the \$20 million in equity of the more evenly balanced Firm, in spite of the fact that Firm is more valuable with a debt-equity ratio of one.

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<sup>35</sup> See Skeel, *supra* note 4, at 948.

<sup>36</sup> For an overview of some of debt's many advantages within a firm's capital structure, see OLIVER HART, *FIRMS CONTRACTS AND FINANCIAL STRUCTURE* 95-155 (1995). These advantages include tax considerations (interest payments to creditors are deductible from corporate tax obligations, while dividends are taxed at both the corporate and personal levels), *see, e.g.*, Franco Modigliani & Merton Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 48 AM. ECON. REV. 261 (1963), the value of preventing a manager from squandering free cash flows by requiring the manager to pay out cash regularly in the form of interest, *see, e.g.*, Michael C. Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure*, 3 J. FIN. ECON. 305 (1976), avoidance of the lemons problem (investors are more wary of firms issuing equity than firms issuing debt because investors suspect that any firm that issues additional equity must be pessimistic about its future prospects), *see, e.g.*, Stewart Myers & Neil Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors do not Have*, 13 J. FIN. ECON. 187 (1984). Disadvantages of debt include increasing the risk of a costly bankruptcy reorganization and/or investment skewing financial distress. *See, e.g.*, Gregor Andrade & Steven Kaplan, *How Costly is Financial (Not Economic) Distress?*, 53 J. FIN. 1443 (1998).

## **b) Skewed Incentives for Getting a Plan of Reorganization Confirmed**

To get a plan of reorganization confirmed by a bankruptcy court, the plan must satisfy Section 1123(a)(4), which requires that a plan “provide the same treatment for each claim or interest of a particular class.”<sup>37</sup> Equity compensation plans, however, give managers incentives to understate the value of equity in order to get a plan confirmed that maximizes the value of the manager’s stake in the reorganized company’s equity. Because managers often have the best information about the true value of the company, such skewed incentives may wreak havoc with the ability of courts to ensure that Section 1123(a)(4) is observed.<sup>38</sup>

Note that even though there is only one class of unsecured creditors of Firm, some of these creditors might prefer equity in the reorganized entity while others prefer debt. Furthermore, the manager will have the best estimate of the true value of Firm. Other parties must either rely on Manager’s estimates or expend considerable sums in developing their own estimates.

Under these conditions, Manager might have a strong incentive to understate the value of the firm for two reasons. First, the smaller the perceived value of equity, the smaller the manager’s perceived compensation. Because outrage at outsize payments may limit the manager’s ability to obtain outsize payments, the manager will have an incentive to underestimate the value of equity. Second, if the manager continues in her role at the reorganized firm, then the manager’s future employers will be the other

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<sup>37</sup> 11 U.S.C. § 1123(a)(4).

shareholders in the reorganized firm. The manager might want to gain favor with her future employers by underestimating the value of their equity, thereby leading to windfall returns for those taking equity with respect to those taking debt. In total, these inefficient incentives may cause significant additional complications in the already arduous process of getting different creditors to agree to different securities in the context of a plan of reorganization.

Thus, while pay-for-performance managerial compensation plans in bankruptcy offer the promise of improved managerial performance, existing practice and proposals suffer from several flaws. Professor Skeel explicitly notes the value of “continued experimentation” in this area.<sup>39</sup> Along these lines, the next Part proposes a new plan, unsecured debt compensation for managers, that addresses many of the flaws discussed in this Part while preserving the advantages of pay-for-performance.

### ***C. Enron as an Example of the Deficiencies of Current Methods of CEO Compensation in Bankruptcy***

The Enron bankruptcy highlights many of the dangers of managerial compensation in bankruptcy described above. Once Enron declared bankruptcy, it hired a new manager, Stephen Cooper, head of the turnaround firms<sup>40</sup> Kroll Zolfo Cooper, LLC and Stephen Forbes Cooper, LLC.<sup>41</sup> Cooper was granted an annual salary of \$1.32 million and his firm was guaranteed a bonus of at least \$5 million if Enron avoided

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<sup>38</sup> For an analysis of the difficulties plaguing the valuation process in bankruptcy, see Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV 403 (2005).

<sup>39</sup> See Skeel, *supra* note 4, at 949.

<sup>40</sup> A “turnaround firm” is a firm that specializes in improving the fortunes of bankrupt or distressed companies.

<sup>41</sup> See Floyd Norris & David Barboza, *Lay Sold Shares for \$100 Million*, N.Y. TIMES, February 16, 2002.

liquidation.<sup>42</sup> The full size of the bonus was ultimately subject to the bankruptcy court's approval at the conclusion of the Enron bankruptcy.<sup>43</sup> Note the dangers inherent in these terms. Cooper's salary did nothing to enhance his incentives to maximize the value received by the firm's creditors. Cooper's bonus gave him an incentive to avoid liquidation. If liquidation were the efficient option, then this incentive was inefficient. Even if liquidation was inefficient, Cooper's incentives were misplaced. Once Cooper succeeded in avoiding liquidation, he had few direct incentives to take further steps to maximize the value of Enron's assets.

These deficiencies in managerial compensation explain many of the failings of the Enron bankruptcy. Given Cooper's incentives, it should be no surprise that Cooper had Enron hire many employees of Kroll, Zolfo, Cooper (his primary employer). By the end of Enron's bankruptcy, Enron had paid Kroll Zolfo Cooper over \$63 million dollars in fees.<sup>44</sup> As a principal in Kroll Zolfo, Cooper clearly benefited from the fees earned by Kroll Zolfo. It is less clear, however, that these fees benefited Enron. Cooper's contract gave him no incentive not to incur such fees; so long as the fees helped avoid a liquidation and could be explained to the bankruptcy court as reasonable, Cooper had every incentive to hire his colleagues, even if these hires did not maximize Enron's value. Similarly, Cooper had no incentive to reduce the size of Enron's legal bills. High legal bills may have reduced the probability of liquidation and thereby enhanced Cooper's expected bonus, even if the legal fees did not ultimately raise the creditors' return. In

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<sup>42</sup> See Norris & Barboza, *supra* note 41.

<sup>43</sup> See Jonathan Sempel, *Enron CEO's Firm Seeks "Success Fee"*, REUTERS, Sept. 3, 2004 (stating that Kroll Zolfo Cooper LLC "asked a bankruptcy judge for a ... success fee", clearly implying that the fee was subject to court approval). See Entwistle & Cappuci LLP, "Enron Corporation Bankruptcy Proceedings: Recent Developments," (2002), <http://www.entwistle-law.com/news/institutional/enron/enron9.htm>.

<sup>44</sup> See Sempel, *supra* note 43.

light of these factors, the “priciest ever”<sup>45</sup> bankruptcy fees of approximately \$1 billion dollars incurred by Enron’s estate become easier to understand. Of course, these fees may have created even more than \$1 billion of value for Enron. The skewed incentives created by Cooper’s employment contract, however, ensure that suspicion about the fees will linger.<sup>46</sup>

The difficulty of providing performance incentives in bankruptcy is further exemplified by Kroll Zolfo Cooper’s request for bankruptcy court authorization for a \$25 million “success fee” at the conclusion of Enron’s bankruptcy.<sup>47</sup> In spite of the high fees billed to Enron by Kroll Zolfo Cooper employees, Kroll Zolfo claimed that its was entitled to the success fee because it had produced “extraordinary results for the bankruptcy estate.”<sup>48</sup> Kroll Zolfo Cooper may well have been telling the truth. The unclear criteria for granting pay-for-performance compensation in bankruptcy, however, prevented creditors or the bankruptcy court from having confidence that the success fee was a pay-for-performance measure rather than a windfall to Kroll Zolfo created by the fact that the head of Kroll Zolfo was also the head of Enron. Thus, whatever one thinks of Stephen Cooper’s performance as Enron’s manager, his compensation contract clearly highlights the need for more effective pay-for-performance designs in bankruptcy.

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<sup>45</sup> Eric Berger, *Enron’s Legal Fees are Priciest Ever*, HOUSTON CHRONICLE, Oct. 18, 2003 available at [www.chron.com/cs/CDA/ssistory.mpl/front/2164668](http://www.chron.com/cs/CDA/ssistory.mpl/front/2164668).

<sup>46</sup> See Berger, *supra* note 45 (quoting many sources suggesting that Enron’s bankruptcy fees were unnecessarily high).

<sup>47</sup> See Sempel, *supra* note 43.

<sup>48</sup> See Sempel, *supra* note 43 (quoting Kroll Zolfo Cooper’s petition for the success fee.)

## IV. Debt Compensation for Managers

### A. *Unsecured Creditors and Chapter 11 Bankruptcies*

Before presenting the debt compensation proposal, it is crucial to establish some context for the proposal's place within a Chapter 11 bankruptcy.<sup>49</sup>

With limited exceptions,<sup>50</sup> the Bankruptcy Code provides that all unsecured creditors enjoy similar rights in bankruptcy. The “adequate protection” clauses of Sections 363 and 364 subordinate unsecured creditors to secured creditors. Otherwise, several provisions of the Code require that similarly situated unsecured creditors receive similar treatment in any plan of reorganization or liquidation of a bankrupt company.<sup>51</sup> In other words, similarly situated creditors share pro-rata.<sup>52</sup> However, the “fair and equitable” provisions do not simply provide that all unsecured creditors get the same return on their money. Some unsecured creditors may be contractually senior to other unsecured creditors. If this is the case, then the “absolute priority rule” requires that the

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<sup>49</sup> Most large insolvencies occur in Chapter 11. *See, e.g.,* Bris, et al., *supra* note 14, at Tbl. 1-2 (showing more corporate bankruptcies proceeding within Chapter 11 than Chapter 7 and presenting data to show that the assets of Chapter 11 companies are much greater than companies in Chapter 7). Note, however, that committees may also be appointed in Chapter 7 liquidations. 11 U.S.C. § 705(a) (providing that unsecured creditors of a debtor in Chapter 7 may elect a creditors' committee).

<sup>50</sup> A few narrow classes of unsecured claims enjoy priority over other unsecured creditors. *See* 11 U.S.C. § 507(a).

<sup>51</sup> *See, e.g.,* 11 U.S.C. § 1129(b)(1) (providing that a plan of reorganization should be confirmed “if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan”). *See also* 11 U.S.C. § 1123 (a)(4) (requiring a plan of reorganization to “provide the same treatment for each claim or interest of a particular class”).

<sup>52</sup> Pro-rata distribution means that every creditor in a given class gets the same proportion of the face value of their claims. To illustrate, if one member of a class receives sixty cents for each dollar of debt, then all other members of the class should receive the same amount.

senior unsecured creditors get paid in full before the junior unsecured creditors receive any payments.<sup>53</sup>

When a company files for Chapter 11 bankruptcy, a committee (“the committee”) is formed to represent the interests of unsecured creditors in the bankruptcy.<sup>54</sup> Section 1102(b)(1) of the Bankruptcy Code stipulates that representatives of the seven largest unsecured creditors should make up the committee. Alternatively, the code allows the committee to be composed of other willing creditors, so long as the creditors serving on the committee are “representative of the different kinds of claims to be represented.”<sup>55</sup> In practice, the committee is often chosen to be representative of the interests of a diverse group of creditors. Unless the court finds that other committees are necessary because of conflicts of interests between unsecured creditors,<sup>56</sup> the creditors’ committee is therefore well placed to represent the interests of unsecured creditors in a coherent fashion and to mediate conflicts between unsecured creditors.

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<sup>53</sup> See 11 U.S.C. § 1129(b)(2)(B) (requiring that “ (i)the plan [of reorganization] provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property”).

<sup>54</sup> See 11 U.S.C. §1102(a).

<sup>55</sup> 11 U.S.C. §1102(b)(1).

<sup>56</sup> See BAIRD, *supra* note 1, at 18. In large bankruptcies, several committees may be formed to represent the interest of unsecured creditors with different contractual rights to the assets of the bankrupt company. See 11 U.S.C. §1102(a)(2) (providing that “On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The U.S. Trustee shall appoint any such committee”). Although a variety of factors are pertinent to this two step evaluation, courts tend to focus on: (1) the presence of conflicted interests between the moving parties and the existing committee; (2) the costs associated with appointment; and (3) the stage of the case. See *In re Hills Stores*, 137 B.R. 4, 6 (Bankr. S.D.N.Y. 1992); *In re McLean Industries, Inc.*, 70 B.R. 852, 859 (Bankr. S.D.N.Y. 1987).

## **B. Debt Compensation for Managers**

Part III detailed the difficulty of “incentivizing” managers in bankruptcy. To improve managerial performance, I propose that the creditors’ committee of a firm in bankruptcy be granted the right to award managers a percentage of the unsecured debt of the insolvent firm.<sup>57</sup> This right to grant debt compensation can be created in one of two manners. First, a statute might establish that the creditors’ committee has the right to grant debt compensation. Alternatively, the board of directors of the debtor might write a compensation contract granting a percentage of the unsecured debt to the manager. This compensation will be subject to creditors’ committee approval.<sup>58</sup> Because the bankrupt corporation’s board of directors may not zealously pursue the creditors’ best interests (in spite of the board’s fiduciary duties), the statutory route is preferable; the statutory route enables the creditors’ committee to implement debt compensation without interference from the board of directors.

Under either mechanism (statutory or ad hoc), if the majority of the members of the unsecured creditors’ committee approve a given percentage of debt compensation and the percentage meets a number of guidelines detailed *infra*, then the manager should receive the given percentage of all the non-contingent unsecured claims on the

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<sup>57</sup> Although this Article focuses on Chapter 11 bankruptcies, if a committee exists in a Chapter 7 bankruptcy, *see* 11 U.S.C. § 705(a), then this committee should have the same powers as the unsecured creditors’ committee of a Chapter 11 debtor.

<sup>58</sup> Because creditors are the typical residual claimant in bankruptcy, any compensation contract chosen by the board of directors effectively spends the creditors’ money. As a result, allowing the corporation’s board of directors to grant debt (a cost imposed on the creditors) is not as radical a departure as it may seem-- the compensation granted to the manager comes from the creditors in either case. As shown below, debt compensation provides many advantages to the creditors that are unobtainable with ordinary compensation contracts. Unsecured creditors may therefore prefer debt compensation to other forms of managerial compensation.

company<sup>59</sup>. Upon the confirmation of a plan of reorganization, the manager receives the given percentage of whatever the original creditor receives in lieu of debt. If debt in the original company is transformed into equity in the reorganized company, then the manager receives a percentage of equity. If the unsecured debt is transformed into debt in the reorganized company, then the manager receives a percentage of this debt claim.<sup>60</sup> Every unsecured creditor is bound by this decision of the committee. Equity claimants should also be allowed to grant the manager a percentage, but the percentage must be the same as that granted by the general unsecured creditors. The committee's right to grant debt compensation should not be absolute, however. Indeed, the court should have the right to veto the proposal if it feels that the proposal unduly jeopardizes the interests of other interested parties. The risks of debt compensation and the appropriate responses to these risks will be covered in Part IV, *infra*.

Our example helps illustrate how the proposal would operate. For the moment, assume for simplicity that the value of Firm is realized in cash upon liquidation or reorganization at the moment Firm successfully concludes bankruptcy.<sup>61</sup> Now suppose that the unsecured creditors' committee of Firm chooses (by majority vote) to adopt the debt compensation scheme and award Manager 3% of the unsecured debt of the firm. Following this vote, every unsecured creditor must relinquish 3% of the face value of their debt to Manager. If creditor A owns debt with a face value of \$1 million, then the manager will receive debt with a face value of  $\$30,000 = .03 * \$1 \text{ million}$  from creditor A.

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<sup>59</sup> If a contingent claim subsequently becomes non-contingent (e.g., through a judgment in a lawsuit), then the manager should be awarded the agreed upon percentage whenever the claim is no longer contingent.

<sup>60</sup> Part V.D examines the consequences of allowing managers to hold debt claims in the reorganized company.

<sup>61</sup> In reality, Manager would receive the same securities that the original creditor received in exchange for their unsecured debt. This complication will be discussed in further detail in Part V.D *infra*.

Creditor A will be left with unsecured debt with a face value of \$970,000. In total, Manager will get unsecured debt in Firm with a face value of \$1.5 million = .03 \* \$50 million, where \$50 million is the total face value of Firm's unsecured debt (Assumption 1).

Now suppose that the value of Firm in reorganization is \$15 million and that Manager receives no salary other than the percentage of the unsecured debt. Efficiency dictates that Firm should be liquidated because its liquidation value of \$20 million (Assumption 2) is greater than the reorganization value of \$15 million. In ordinary circumstances, however, Manager might be reluctant to liquidate rather than reorganize because, among other things, liquidation means Manager is out of a job. For this example, assume that Manager values a future job with Firm at \$100,000.

Now compare Manager's salary under the debt compensation scheme if Manager chooses to liquidate versus reorganize. If Manager liquidates, Firm realizes \$20 million. The absolute priority rule provides that secured creditors, whose claim is \$10 million, get paid in full. This means that \$10 million remains for unsecured creditors (equity gets nothing), who have a face value of \$50 million in claims. The "fair and equitable" principle provides that the unsecured creditors must share pro-rata.<sup>62</sup> Thus, each creditor receives twenty cents for each dollar of face value ( $.20 = \$10\text{m}/\$50\text{m}$ ). The Manager's debt has a face value of \$1.5 million. Thus, the manager receives \$300,000 =  $.20 * \$1.5\text{m}$ .

If Manager chooses to reorganize, then Firm realizes \$15 million in value. After paying the secured creditors, Firm is left with \$5 million for unsecured claimants. Each

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<sup>62</sup> See *supra* note 51.

unsecured creditor gets ten cents on the dollar ( $.1 = \$5\text{m}/\$50\text{m}$ ). Manager receives  $\$150,000 = .1 * \$1.5\text{m}$ .<sup>63</sup>

Manager's compensation under reorganization is \$150,000 less than Manager's return under liquidation. Recall that Manager valued the prospect of a future job with Firm if Firm reorganized at \$100,000. Thus, our self-interested Manager will make the efficient choice (liquidation) because the liquidation yields greater overall benefits to Manager than reorganization. Without the debt compensation scheme, however, Manager would have made the inefficient choice—reorganization—because reorganization ensured Manager of a job. For example, if Manager received the same salary under liquidation or reorganization, then Manager would choose reorganization because it gives him a future job with a value of \$100,000.

Note that, by ensuring that Manager chose the efficient option—liquidation—the debt compensation scheme created value for unsecured creditors. For example, although Creditor A gave up 3% of her debt to Manager, Creditor A has benefited because she realized a greater return on the face value of her debt. With liquidation, Creditor A's debt is worth  $.20 * \$970,000 = \$194,000$ . Without debt compensation, by contrast, Manager would choose reorganization, leaving Creditor A with  $\$100,000 = .1 * \$1\text{m}$ .<sup>64</sup> Thus, an unsecured creditor might have good (and efficient) reasons to relinquish some debt in order to improve Manager's incentives.

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<sup>63</sup> Recall that Manager was granted debt with a face value of \$1.5 million.

<sup>64</sup> Note that this example understates the benefit of debt compensation versus salary for Manager because it assumes that, if debt compensation is not adopted, Manager's salary is zero—an obviously unrealistic assumption.

### **C. Why Debt compensation *is an Improvement Upon Existing Means of Managerial Compensation in Bankruptcy***

In the preceding example, it was no coincidence that debt compensation facilitated the efficient result. Debt compensation aligns the incentives of managers with the incentives of the typical residual claimants in bankruptcy—the unsecured creditors. As a result, debt compensation encourages a manager to self-interestedly pursue actions that improve the return of the unsecured creditors. Just as grants of stock options and restricted stock are believed to foster good behavior in managers of solvent firms, so too does unsecured debt compensation promote value-maximizing behavior in managers of bankrupt firms. This alignment of a manager’s incentives with those of bankruptcy’s typical residual claimants makes debt compensation an improvement upon other pay-for-performance plans and proposals.

#### **1. Improvement Over Pay-to-Stay Bonuses**

Just like pay-to-stay bonuses, debt compensation provides an incentive for managers to remain with an insolvent firm. A manager who might receive a percentage of the unsecured debt in the firm enjoy the prospect of a large payment upon the completion of bankruptcy. As a result, debt compensation should accomplish the goal of pay-to-stay bonuses—decreasing the incentive of managers to leave the “sinking ship”.<sup>65</sup> Unlike pay-to-stay bonuses, debt compensation accomplishes additional goals as well. By aligning incentives as well as providing the manager and incentives to stay with the firm,

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<sup>65</sup> See *supra* Part III.B.1.

debt compensation offer more performance for a given dollar of compensation expenditures, making debt compensation clearly superior to simple pay-to-stay bonuses.

## 2. Improvement over Rapid Reorganization Bonuses

As discussed *supra*,<sup>66</sup> reorganization speed is only loosely correlated with efficiency. As a result, rapid reorganization bonuses may engender value-destroying incentives for manager. Debt compensation, by contrast, correlates managerial compensation much more closely with value-maximization. Consequently, debt compensation performs better in improving managerial performance.

Recall our example in Part III.B.2, wherein Manager faced a decision to hire consultants that would speed the reorganization process. Suppose that if Manager does not hire the consultants, Firm will be worth \$30 million in reorganization. If Manager hires the consultants, Firm will be worth \$35 million in reorganization (because of a faster reorganization), but Firm will incur \$10 million in costs, for a net value of \$25 million. The unsecured creditors would prefer if Manager does not hire the consultants because they cost more than they are worth. If Manager is receiving a rapid reorganization bonus, however, Manager will have an incentive to hire the consultants regardless.

Now assume that Manager receives debt compensation of 3% of the face value of unsecured debt. If Manager hires the consultants, then (after paying the secured claimants in full), \$15 million remains for unsecured creditors.<sup>67</sup> Unsecured creditors thereby receive thirty cents on the dollar ( $.3 = \$15m/50m$ ). Manager's \$1.5 million in debt

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<sup>66</sup> See *supra* Part III.B.2.

is thus worth  $\$450,000 = .3 * 1.5m$ . If Manager chooses not to hire the consultants, then \$20 million remains for unsecured creditors in reorganization,<sup>68</sup> meaning that they receive forty cents on the dollar. ( $.4 = \$20m / \$50m$ ). Manager's compensation is thereby worth  $\$600,000 = .4 * \$1.5m$ . Given the choice, Manager will not hire the consultants—the efficient choice. Thus, this example demonstrates how debt compensation improves upon rapid reorganization bonuses by providing a closer alignment between managerial performance and managerial compensation.

If the consultants add value, however, then Manager will hire them if she is receiving debt compensation. Suppose that the consultants add \$15 million in value while costing \$10 million. In this case, \$25 million remains for unsecured creditors after secured creditors are satisfied. Manager's debt is worth  $\$750,000 = (\$25m / \$50m) * \$1.5m$ . Because \$750,000 is greater than the \$600,000 that Manager receives if the consultants are not hired, Manager will hire the consultants, as efficiency dictates. Debt compensation thereby ensures that consultants are hired when they add value and are not hired when they do not add value. Rapid reorganization bonuses, however, bias Manager in favor of hiring consultants even when the consultants do no add value.

### **3. Improvement Upon Percentage of Asset Plans**

Percentage of asset plans help ensure that managers maximize value if liquidation is the clear choice.<sup>69</sup> These plans suffer from two flaws, however. First, if liquidation is not the clear choice, then percentage of asset plans may skew incentives towards

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<sup>67</sup> Hiring the consultants makes the net value of Firm \$25 million. Secured creditors are owed \$10 million, leaving a residual value of \$15 million for unsecured creditors.

<sup>68</sup> Not hiring the consultants makes the value of Firm \$30 million. After paying the secured creditors in full, this leaves \$20 million for unsecured creditors.

inefficient liquidation. Second, they may be overly expensive. Debt compensation, by contrast, provides efficient incentives for manager to choose between liquidation and reorganization in all contexts. Debt compensation also provides higher-powered incentives than percentage of assets plans, making it less expensive than percentage of asset compensation plans.<sup>70</sup>

Recall the example presented in Part III.B.3.a). Firm is worth \$15 million in reorganization and \$10m in liquidation. If Manager gets 3% of assets in liquidation and an \$80,000 salary upon reorganization, then Manager will choose liquidation, in spite of the fact that reorganization is the efficient choice. Consider the same scenario when the manager receives 3% of unsecured debt. If Manager chooses liquidation, then Manager's debt is worth nothing. Firm is worth \$10 million. All of this value goes to pay secured creditors, leaving unsecured creditors with nothing. Manager's debt, which is unsecured, therefore receives nothing. If Manager chooses reorganization, however, then \$5 million will be left over after secured creditors are compensated. Manager's \$1.5m is therefore worth  $\$150,000 = \$1.5m * (\$5m / \$50m)$ . Thus, Manager will choose reorganization—the efficient choice.

Again, debt compensation encourages Manager to make the efficient choice by closely aligning Manager's incentives with the interests of the residual claimants. Debt compensation may also enable more high-powered and less expensive incentives than percentage of asset plans.

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<sup>69</sup> See *supra* Part III.B.3.

<sup>70</sup> Although debt compensation plans are less expensive than percentage of asset plans, cost remains an important obstacle to the use of debt compensation. See the discussion in Part V.A *infra*.

Returning now to the example in Part III.B.3.b), suppose that liquidation is the best option for Firm. With good managerial performance, the liquidation value of Firm will be \$12 million; with bad performance, the liquidation value is \$10 million. Now suppose Manager is awarded 3% of assets. If Manager performs well, she gets  $.03 * \$12\text{m} = \$360,000$  while if Manager performs poorly, she gets  $.03 * \$10\text{m} = \$300,000$ . Under these assumptions, the percentage of assets plan provides Manager with appropriate incentives. Because Manager shares the increase in value with creditors, Manager will self-interestedly attempt to garner the high liquidation value for Firm.

Manager's incentive to garner the high liquidation value is assured by the percentage of assets plan. Note, however, that the difference between compensation in the good vs. the bad performance states ( $\$60,000 = \$360,000 - \$300,000$ ) is a small percentage of the total compensation of over \$300,000. The percentage of assets plan may therefore be called "low-powered" in the sense that it requires a considerable total expenditure of money to create sufficient incentives for the appropriate managerial behavior;<sup>71</sup> over \$300,000 must be spent to generate \$60,000 in incentives.

Contrast this with the outcome using debt compensation. Suppose that the unsecured creditors grant Manager 3% of unsecured debt. If Manager performs poorly, then Firm is worth \$10 million. This amount only suffices to compensate the secured creditors. Unsecured creditors receive nothing. As a result, Manager's 3% stake in unsecured debt has no value. If Manager performs well, by contrast, then Firm is worth \$12 million. After paying the secured creditors, unsecured creditors are left with \$2

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<sup>71</sup> See *supra* note 34 for a definition of low-powered incentives.

million, meaning they get four cents per dollar of debt.<sup>72</sup> Manager's \$1.5 million in face value is therefore worth  $\$60,000 = .04 * \$1.5m$ .

Debt compensation gives Manager the same incentive to attain the good result (an additional \$60,000) as the percentage of assets plan. Debt compensation provides this incentive much more cheaply, however. Whereas the percentage of assets plan gave Manager at least \$300,000 in any scenario, debt compensation only rewards compensation for good performance. Debt compensation therefore offers higher powered incentives than percentage of assets plans.<sup>73</sup>

Debt compensation achieves higher-powered incentives by not offering Manager a percentage of the secured debt. This makes good sense. Secured creditors do not need to compensate Manager. No matter how Manager performs, the secured creditors receive their money. As a result, granting Manager a percentage of Firm that is reserved for secured creditors is wasteful.<sup>74</sup> The debt compensation approach avoids this problem by granting Manager a percentage of unsecured debt exclusively.

Debt compensation therefore ameliorates two of the primary flaws of the percentage of assets plan. Debt compensation does not skew incentives to liquidate, nor does it cost as much as the percentage of assets plan.

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<sup>72</sup>  $.04 = \$2m / \$50m$ .

<sup>73</sup> In reality, of course, Manager will always receive some compensation. The purpose of the example is to show that debt compensation creates tailored incentives that are superior to the blunt approach of the percentage of assets scheme.

<sup>74</sup> In the typical bankruptcy, secured creditors get paid in full. *See* Bris et. Al, at Tbl. 1 (indicating that secured creditors are paid in full in 90% of bankruptcies. Thus, the example is realistic in suggesting that secured creditors get paid in full in every eventuality.

#### 4. Improvement Over Equity Compensation Plans

As explained in Part III.B.4, equity compensation plans suffer from a number of defects. Two prominent defects include skewed incentives to create an efficient capital structure and skewed incentives to provide accurate valuations of debt as opposed to equity. Debt compensation mitigates or eliminates both of these defects.

Debt compensation gives managers incentives to shape the efficient capital structure for the reorganized firm. To illustrate, return to the example presented in III.B.4.a). In this version of the example, a debt-equity ratio of one to one adds value to the reorganized Firm by mitigating agency problems.<sup>75</sup> Firm is worth \$40 million with this debt/equity ratio but only \$30 million when the Firm has an all-equity structure. If Manager receives equity compensation, she has incentives to fashion a less efficient all-equity capital structure because the greater the value of equity, the greater Manager's return.

With debt compensation, by contrast, Manager will choose the appropriate capital structure. Assume that Manager receives 3% of unsecured debt. If Manager chooses the all-equity capital structure, then \$20 million remains for unsecured creditors after secured creditors are satisfied. Manager's \$1.5 million face value debt will therefore be worth  $\$600,000 = \$1.5m * (\$20m / \$50m)$ . If Manager chooses the more balanced capital structure, by contrast, then \$30 million remains for unsecured creditors, meaning that Manager receives  $\$900,000 = \$1.5m * (\$30m / \$50m)$ . Thus, Manager will choose the efficient capital structure when receiving debt compensation. Because reorganization of the capital

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<sup>75</sup> For an explanation of how debt's presence in capital structure can add value, see *supra* note 36.

structure comprises one of Manager's essential roles in bankruptcy, this feature of debt compensation constitutes a significant advantage over equity compensation plans.

With debt compensation, Manager will also have no incentive to overvalue debt with respect to equity. If Manager produced an overestimate of the value of debt in the reorganized company relative to equity, then Manager's equity compensation is underestimated. While Manager may prefer this combination when receiving equity compensation because it understates the value of her compensation, she has no such incentive with debt compensation. So long as Manager provides a reasonably accurate description of the total value of the company, her total compensation will appear the same regardless of whether she exaggerates the value of one class of securities with respect to another. As a result, Manager has no incentive to misestimate the values of different securities. With greater confidence in Manager's valuations, creditors can place more reliance on these estimates when choosing whether to vote for a plan of reorganization. Courts will also benefit from greater confidence in Manager's estimations when deciding to confirm or reject a plan of reorganization.<sup>76</sup>

This section examined the superiority of debt compensation with respect to many alternative forms of managerial compensation in bankruptcy. Unlike these other compensation structures, debt compensation provides incentives for efficient managerial actions without creating incentives to distort the process of reorganization. As such, debt

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<sup>76</sup> A plan of reorganization must meet several criteria in order to receive court approval. Whether or not a plan meets the criteria will depend critically on valuations of different securities. For example, it is impossible to know if a plan meets the "best interests of the creditors" test without evaluating the disbursements to claimants. *See* 11 U.S.C. § 1129(a)(7) (describing what is commonly called the "best interests of the creditors" test and requiring that all claims of a given class must receive the same treatment.

compensation presents an important new tool for improving managerial performance in bankruptcy.

## **5. Improvement of the Functioning of the Creditors' Committee**

At present, creditor participation on the creditors' committee suffers from free rider problems.<sup>77</sup> When a creditor joins the creditors' committee and monitors the debtor, all of the creditors share the benefits of the increase in value caused by monitoring. Only the creditors on the committee bear the costs of monitoring, however—the other creditors free ride on the benefits of the committee's monitoring.<sup>78</sup> As a result, creditors are reluctant to join the creditors' committee or to monitor the debtor efficiently if they do join. The free rider problem therefore undermines the effectiveness of the creditors' committee in protecting the creditors' interests.

Debt compensation mitigates this problem in a number of ways. By aligning the incentives of managers with those of creditors, debt compensation reduces the need for monitoring. With debt compensation, the manager self-interestedly pursues actions that benefit the creditors, decreasing the importance of effective creditor monitoring. The salience of the free rider problem is thereby reduced.

Debt compensation also raises the incentive for creditors to join the creditors' committee. Debt compensation confers an important new power on the creditors' committee. Creditors who serve on the committee will have the ability to influence the

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<sup>77</sup> J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 271 (1991) (stating that "It is not surprising, considering the forgoing list, why unsecured creditors are hesitant to become members of a creditors' committee. It is clearly to the advantage of an unsecured creditor to adopt a "free-rider" strategy

use or non-use of debt compensation. This power will be particularly important to the largest creditors who will have the greatest to gain or lose through debt compensation. Consequently, debt compensation raises the incentive for creditors, and particularly large creditors, to join the committee by adding to the advantages of committee service. Large creditors are often the most sophisticated parties with the best ability to monitor. In addition, large creditors suffer comparatively smaller free rider problems. If one creditor holds half the debt of a bankruptcy company, then that creditor enjoys half the gains of its monitoring efforts while bearing all the costs of these efforts. While this creditor will monitor less than the efficient amount because of mismatched incentives, the large creditor's monitoring efforts should be greater than those of a small creditor. The small creditor garners a much smaller proportion of the gains of monitoring than the large creditor while continuing to bear the full cost of the monitoring efforts. By raising the incentive for large creditors to serve, debt compensation also reduces free rider problems in this fashion. By raising the incentive for creditors with superior monitoring ability to join the creditors' committee, debt compensation improves the ability of the committee to monitor the debtor.

## **V. Weaknesses of Debt Compensation and Potential Responses**

Although debt compensation for managers in bankruptcy offers many advantages over other compensation structures, it is no panacea. Several potential flaws and complications may obstruct debt compensation's efficacy. These flaws include debt

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vis-a-vis the other unsecured creditors and hope that some other unsecured creditor will take the laboring

compensation's expense, the creation of managerial biases in favor of some groups of creditors with respect to others, and the difficulty of unwinding the debt compensation structure once a firm has reorganized. While none of these complications is insoluble, judges and lawmakers must shape the debt compensation approach to ensure that the benefits described above are realized. This Part examines the potential shortcomings of debt compensation and discusses means of mitigating these weaknesses.

### ***A. Debt Compensation's Expense***

High expense may plague the debt compensation approach. As discussed with respect to the percentage of assets plan, percentage compensation provides low powered incentives; improved performance only raises the manager's pay by a small percentage of the total compensation.<sup>79</sup> Moreover, debt compensation bears some resemblance to stock options and other executive compensation plans that have recently fallen into ill-repute for granting managers large windfalls without improving performance.<sup>80</sup> If debt compensation improves performance by a little but costs a lot, then it may not be worth the trouble.

High expense should not obstruct debt compensation for a number of reasons. First, as noted above, debt compensation does not simply award the manager a percentage of the entire firm. Because secured debt is likely to be repaid in any event,

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oar and bear the cost of serving on the committee”).

<sup>78</sup> See BAIRD, *supra* note 1.

<sup>79</sup> For a discussion of low powered incentives, see Michael Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARVARD BUSINESS REVIEW 138 (1990).

<sup>80</sup> For a comprehensive discussion of the failure of “pay-for-performance”, see BEBCHUK & FRIED, *supra* note 3; Michael C. Jensen & Kevin Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). *But see* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653 (1998) (finding that CEO compensation is strongly related to firm performance and attributing this relationship to stock option grants).

managerial incentives are not improved by awarding the manager a percentage of secured debt. In response, debt compensation excludes secured debt. By focusing the incentive compensation on that of the typical residual claimant—the unsecured creditor<sup>81</sup>-- debt compensation facilitates higher-powered incentive compensation.

## 1. Opt-Out for Senior Unsecured Creditors

Excluding secured creditors from debt compensation improves the “power” of debt compensation and ensures that secured creditors will not be forced to pay for compensation that does not yield them considerable benefits. Debt compensation may still be low-powered, however, if secured debt is small relative to unsecured debt. If a bankrupt firm’s entire debt load is unsecured, for example, then the secured debt exception does not foster higher-powered incentives. As a result, debt compensation may prove to be low-powered and cost more than it is worth.

Allowing some senior classes of unsecured creditors to opt-out of debt compensation would heighten the impact of each dollar devoted to debt compensation upon managerial performance. As discussed above, all unsecured creditors are not alike. Some debt contracts give some unsecured creditors priority with respect to other unsecured creditors. The Bankruptcy Code recognizes this eventuality, by providing for the establishment of additional creditors’ committees when “necessary to assure adequate representation of creditors.”<sup>82</sup>

Senior unsecured creditors should be allowed to “opt-out” (as a group) of the debt compensation package. To illustrate, modify Assumption 1 of our example so that there

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<sup>81</sup> See Bris, et. al, *supra* note 11.

are no secured creditors of Firm. Instead, suppose that senior unsecured creditors hold \$15 million in face value debt, while general unsecured creditors are owed \$35 million. Assume that a senior unsecured creditors' committee has been appointed to protect the interests of the senior lenders. Suppose also that Firm will be worth \$20 million or \$25 million, depending on Manager's performance. Finally, assume that the unsecured creditors' committee, representing ordinary unsecured creditors, grants 3% of debt to Manager.

If the unsecured creditors' committee's decision binds all unsecured creditors, then Manager receives  $.03 * 50m = \$1.5$  m of face value of unsecured debt.

$\$450,000 = .03 * \$15m$  of this face value will be in senior unsecured debt, while  $\$1.05m = .03 * 35m$  of this debt will be general unsecured debt. If Firm is worth \$20 million, then the absolute priority rule provides that the senior unsecured creditors get paid in full while the general unsecured creditors receive the \$5 million that remains after the senior unsecured creditors are fully compensated. In this case, Manager's senior unsecured debt is worth \$450,000 while her general unsecured debt is worth  $\$150,000 = \$1.05m * (\$5m / \$35m)$ , for a total compensation of \$600,000. If Firm is worth \$25 million, then Manager's senior unsecured claims are worth \$450,000 while her general unsecured debt is worth  $\$300,000 = \$1.05 * (\$10m / \$35m)$ , for a total of \$750,000. Thus, Manager's salary increases by 25% ( $.25 = \frac{\$750,000 - \$600,000}{\$600,000}$ ) with good performance.

Now allow senior unsecured creditors to opt-out of debt compensation. If there is a senior unsecured creditors' committee (a likely outcome when senior unsecured

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<sup>82</sup> 11 U.S.C. § 1102(b).

creditors constitute a large group of creditors),<sup>83</sup> then the committee should vote over whether or not to participate in the debt compensation plan by awarding the manager the same percentage of senior debt chosen by the official unsecured creditors' committee. When there is no senior creditors' committee, senior creditors should vote to opt-in or opt-out of the debt compensation. If a majority (by value) of a given class of senior creditors votes to opt-out of debt compensation,<sup>84</sup> then Manager will receive no senior debt. If a majority (by value) of a given class of senior creditors chooses to join debt compensation, then Manager receives a percentage of all the senior debt (including the debt of those who vote against the proposal).<sup>85</sup>

In our example, senior unsecured creditors will vote to opt-out of debt compensation. No matter how Manager performs, Firm will be worth more than \$15 million, meaning the senior creditors are paid in full under any eventuality. As a result, senior creditors will refuse to relinquish any of their debt as compensation to the manager. The opt-out by senior creditors renders debt compensation a higher powered and less expensive means of compensation. When senior creditors opt-out, Manager receives \$1.05m in face value of general unsecured debt, which is 3% of the total general unsecured debt. If Manager performs poorly, she earns  $\$150,000 = \$1.05m * (\$5m / \$35m)$ ; when she performs well she receives  $\$300,000 = \$1.05 * (\$10m / \$35m)$ .

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<sup>83</sup> Some courts have stated that the "chief concern [in deciding whether or not to appoint an additional committee]. . . is whether different classes of debt and equity holders may be treated differently under [the] plan and need representation through appointment of additional committees." *In re Drexel Burnham Lambert Group, Inc.*, 118 B.R. 209 (Bankr. S.D.N.Y. 1990). Conflicts between senior creditors and other creditors are extremely common when there is a large group of senior unsecured creditors. In these circumstances, it is quite likely that a committee will be appointed to represent senior unsecured creditors.

<sup>84</sup> Alternatively, opting out of a debt compensation may be required to have a two thirds by value and a majority by number of senior unsecured creditors. This two-thirds in amount, one-half in number rule is the standard used for confirmation of a plan of reorganization by an impaired class of creditors.

<sup>85</sup> For a discussion of why a majority vote should be binding on all creditors, see *infra* Part V.B.1.

The absolute size of the incentive for Manager to perform well (an extra \$150,000) is the same whether or not senior creditors choose to opt-out. When senior creditors opt-out, however, the total cost of managerial compensation goes down by \$450,000 because senior creditors are not forced to turn over debt to the manager. Thus, allowing senior creditors to opt-out reduces the potentially high costs of debt compensation while retaining the same positive impact of managerial incentives.

## **2. Debt Compensation is a Voluntary Plan**

The strongest defense against debt compensation's high expense is that it is voluntary. Creditors' committees choose whether or not to award debt compensation. If debt compensation is not worth the expense, the committee is free to reject it. If creditors believe that debt compensation is worth the cost, however, then the law should facilitate the use of debt compensation. Just as shareholders of corporations are free to grant equity to managers to improve managerial compensation, so too should creditors be allowed to arrange similar pay-for-performance plans in bankruptcy.

Many commentators criticize non-bankruptcy pay-for-performance plans for promising more than they deliver. If a manager effectively controls a board, for example, then the manager may be able to garner outsize compensation that is labeled "pay-for-performance" but is actually an outsized handout that provides little incentives to the manager.<sup>86</sup> "Pay-for-performance" underperforms ordinary compensation in these circumstances.

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<sup>86</sup> For a discussion of how "pay-for-performance" plans often fail to achieve their promise, see BEBCHUK & FRIED, *supra* note 3.

While these flaws caution against slavish reliance on pay-for-performance, they are unlikely to be as salient with regards to debt compensation in bankruptcy. A manager is unlikely to enjoy the same control over a creditors' committee that they sometimes enjoy over a board of directors.<sup>87</sup> As commanded by statute, creditors' committees must be composed of large or representative creditors.<sup>88</sup> A manager cannot nominate candidates, nor does the manager have a seat on the committee. As a result, a manager cannot dominate a creditors' committee in the same way that a manager might dominate a board of directors. Debt compensation for managers in bankruptcy is therefore more likely to reflect sound business decision making by the creditors' committee than rent-seeking behavior by the manager.

In spite of debt compensation's voluntariness, courts should remain vigilant for abuses. If a court feels that debt compensation results from managerial domination of the creditors' committee rather than business fundamentals, the court should reject the debt compensation plan.<sup>89</sup> By requiring the approval of a third party to grant debt compensation, the worst managerial compensation abuses should be avoided.

## ***B. Conflicts Between Creditors Caused by Debt Compensation***

Some creditors may be harmed by debt compensation. If debt compensation causes managers to favor one group of creditors over another, then its benefits may be

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<sup>87</sup> For examples of the way managers can sometimes dominate the board of directors of companies outside of bankruptcy, see Michael Wolf, *Media Mutiny*, WALL ST. J., Dec. 8, 2003.

<sup>88</sup> See 11 U.S.C. § 1102(b).

<sup>89</sup> Although such decisions are typically difficult for courts to determine, the detailed involvement of the court with the affairs of a bankrupt company means that the court will have some basis on which to make

outweighed by its costs. While fears of inefficient behavior by debt-compensated managers may be overstated by some groups of creditors, there will be occasionally be some merit to these claims. To prevent debt compensation from causing inefficient managerial behavior, courts should follow some of the guidelines presented here before approving a debt compensation plan.

As a general matter, it should be emphasized that the fact that some groups of creditors are harmed by debt compensation is not reason to doubt it. Bankruptcy procedures strive to obtain the greatest value from the bankrupt firm, not to satisfy any particular group of creditors.<sup>90</sup> If debt compensation maximizes value while harming one group of creditors, then debt compensation adds value and should be encouraged.

## **1. Conflicts Among General Unsecured Creditors**

Although it is unlikely that all general unsecured creditors will be happy with the decision to grant debt compensation, all general unsecured creditors must be bound by the decision of the creditors' committee.

Binding all creditors prevents free riding by some creditors. If some general unsecured creditors opt-out of granting debt compensation while others support the plan, the "opt-outers" gain the performance enhancing benefits of debt compensation without having to pay for them. The potential to be a free rider by opting out may convince many creditors to vote against an efficient debt compensation plan. To prevent this eventuality, a debt compensation award must be binding on all general unsecured creditors.

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the determination. Moreover, the court will have other reasons, described *infra*, to reject debt compensation plans that may result in very large payoffs to managers.

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.<sup>91</sup>

## **2. Conflicts Between Secured Creditors and Unsecured Creditors**

Debt compensation runs against the interests of secured creditors. Because the manager shares when unsecured creditors benefit, the manager may favor unsecured creditors over secured creditors.

In some circumstances, the manager's tendency to favor unsecured creditors may lead to inefficient outcomes. Returning to our example from Part II, modify Assumption 3 to make reorganization a riskier process. If Firm pursues a reorganization, there is a 60% chance that Firm will be worth \$30m and a 40% chance that Firm will be worthless (\$0). Under this assumption, efficiency dictates that the Firm should liquidate because its liquidation value of \$20 million (Assumption 2) is greater than its expected reorganization value of  $\$18m = .6 * \$30m + .4 * \$0m$ .

Debt compensation will not lead to the efficient outcome under these conditions. Under liquidation, \$10m remains for unsecured creditors after compensating secured creditors. Under attempted reorganization, by contrast, unsecured creditors get an

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<sup>90</sup> Cf. DOUGLAS BAIRD, THE ELEMENTS OF BANKRUPTCY 231-32 (4<sup>th</sup> ed. 2006) (describing bankruptcy as an attempt to "make the best of a bad situation" and suggesting that the absolute priority rule is not a critical consideration for today's large bankruptcies).

average receipt of  $\$12m = .6 * (\$30m - \$10m) + .4 * \$0m$ . When Manager receives debt compensation, Manager's percentage of unsecured debt will be worth more (on average) under reorganization than under liquidation. Thus, Manager will choose reorganization, in spite of the fact that liquidation is the efficient choice.

This flaw in debt compensation is not as problematic as it may seem, however. First, in many cases, the secured creditors are comfortably over-secured.<sup>92</sup> As a result, the scenario described above should not occur too frequently. Second, the Bankruptcy Code includes many protections for secured creditors. For example, a debtor may not use an asset that provides security for a creditor without granting that creditor "adequate protection" for that asset.<sup>93</sup> Section 361 of the Bankruptcy Code explains that adequate protection means that the secured creditor should not suffer a loss in value because the debtor continued to use the secured asset in bankruptcy.<sup>94</sup> If pursuing a plan of reorganization risks the loss of the secured creditor's security, the secured creditor can therefore request relief from the automatic stay imposed under by the Bankruptcy Code. Thus, the bankruptcy court will be unlikely to approve actions like the one described above that place the secured creditors of Firm in jeopardy of losing their security. The secured creditor protections offered by the Code thus mitigate the chance that debt compensation will unduly harm secured creditors. As a practical matter, these protections appear to work effectively. Recall that secured creditors are paid in full in

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<sup>91</sup> At times, the creditors' committee may take action to require the debtor itself to take certain actions. *See, e.g., In re Cybergenics*, 330 F.3d 548 (3<sup>rd</sup> Cir. 2003) (en banc).

<sup>92</sup> An oversecured creditor's security interest is worth more than the underlying loan made by the creditor that is secured by the security. The oversecured creditor's interest in the collateral is limited to the value of the claim. 11 U.S.C. § 506(a)(1).

<sup>93</sup> *See* 11 U.S.C. § 362(d)(1) (2004) (granting a secured creditor relief from the automatic stay if the debtor does not provide adequate protection). Once a secured creditor is granted relief from the stay, the creditor can prevent the debtor from using the asset that acts as security (e.g., by foreclosing on the asset).

<sup>94</sup> *See* 11 U.S.C. § 361 (2004).

90% of bankruptcies, suggesting that debt compensation should not unduly harm secured creditors.<sup>95</sup>

In addition, most managers will not receive debt compensation exclusively. Instead, they will be compensated by a combination of salary and debt. The salary constitutes a priority administrative expense.<sup>96</sup> If the “adequate protection” offered to secured creditors proves insufficient, then the remaining funds owed to the secured creditors have priority over managers’ salaries.<sup>97</sup> As a result, managers will experience some loss of compensation if secured creditors are not compensated in full. This provides added protection for secured creditors. In the example presented above, Manager would not receive any salary if she attempted reorganization and Firm had no value. This would make Manager more reluctant to choose an inefficient reorganization over a more efficient liquidation.

If unsecured creditors feel that they have little to lose (i.e. if they are out of the money), then they may be willing to grant the manager a very high percentage debt compensation. A very high percentage might encourage inefficient managerial choices. Returning to our example, modify Assumption 2 to make the value of Firm in liquidation \$10.4 million rather than \$20 million. In addition, modify Assumption 3 to make the value of Firm if it pursues reorganization \$30m with probability of 10% and \$0 with 90% probability. Assume that Manager receives \$400,000 in salary in addition to any debt compensation. Note that under these circumstances, unsecured creditors receive nothing

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<sup>95</sup> See Bris, et. al, *supra* note 11, at tbl. 2.

<sup>96</sup> See 11 U.S.C. § 503(b) (2004).

<sup>97</sup> See 11 U.S.C. § 507(b) (2004).

if the firm liquidates—the liquidation value equals the value of secured claims and Manager’s salary.<sup>98</sup>

Under these circumstances, liquidation is clearly the efficient outcome.<sup>99</sup> If Manager receives debt compensation of 3%, then Manager will choose liquidation. The Manager’s desire to preserve her \$400,000 salary exceeds her incentive to maximize the value of unsecured debt.<sup>100</sup> The unsecured creditors (who receive nothing under liquidation), however, have nothing to lose by granting Manager much higher levels of debt compensation to encourage her to attempt an inefficient reorganization. Suppose that the unsecured creditors grant Manager 50% of the face value of unsecured debt. In this case, Manager chooses reorganization because her pecuniary incentive to maximize the value of her debt compensation exceeds her salary.<sup>101</sup> In spite of the high debt compensation award, unsecured creditors gain as well; by encouraging Manager to choose reorganization, the high debt compensation award opens the possibility that unsecured creditors will receive some compensation. Had unsecured creditors not granted such a high percentage and Manager chose liquidation, then the unsecured creditors would be left with nothing. Thus, in some scenarios, debt compensation can lead to an inefficient outcome despite the presence of managerial salary.

To protect against this outcome, courts should take a number of precautions. First, they should be especially vigilant in protecting secured creditors rights to adequate

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<sup>98</sup> 11 U.S.C. § 503(b) provides that administrative expenses such as salaries receive priority over ordinary unsecured claims. Thus, Manager’s salary must be paid in full before unsecured claimants receive any compensation.

<sup>99</sup> Liquidation realizes \$10m. Reorganization yields an expected value of  $\$3m = .1 * \$30m + .9 * \$0m$ .

<sup>100</sup> If Firm liquidates, Manager receives \$400,000. If Firm reorganizes, Manager receives an expected value of  $.1(\$400,000 + .03(\$30m - \$10.4m)) + .9 * \$0 = \$100,000$  (approximately).

<sup>101</sup> If Firm liquidates, Manager receives \$400,000. If Firm reorganizes, Manager receives an expected value of  $.1(\$400,000 + .5(\$30m - \$10.4m)) + .9 * \$0 = \$1.04m$  (approximately).

protection when managers receive debt compensation. Second, and most importantly, courts should reject debt compensation plans that award overly high percentages to the managers.<sup>102</sup> To determine when a percentage is overly high, courts should compare the percentage of debt received by the debt-compensated manager with the percentage of equity (in the form of stock grants and stock options) granted to managers of similar firms outside of bankruptcy. If the manager's debt compensation percentage is considerably higher than those of her peers outside of bankruptcy, then the court should reject the debt compensation plan because there is a high risk that the plan will create inefficient incentives.

The conflict between secured creditors and unsecured creditors in bankruptcy shares a number of similarities with the conflict between debt claimants and equity claimants in an ordinary company.<sup>103</sup> In these companies, managers are commonly granted stock and stock options, in spite of the fact that such compensation introduces conflicts between creditors' interests and managers' interests. Just as incentive compensation is permitted in these contexts, so too should it be permitted within bankruptcy.<sup>104</sup>

The threats caused by incentive compensation to the interests of senior creditors are real, however. Outside of bankruptcy, these creditors receive protections against

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<sup>102</sup> To give committees and managers an incentive to choose reasonable percentages, a rule might be adopted that only one debt compensation plan can be put forward to the court. If the court rejects the debt compensation plan, then debt compensation cannot be used with respect to the manager in question. This will prevent the committee from "pushing the envelope" with its debt compensation proposal, secure in the knowledge that if one plan was rejected, the committee can subsequently modify the plan to ensure court acceptance.

<sup>103</sup> See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F.Supp. 1504 (S.D.N.Y. 1989).

<sup>104</sup> For an analysis of the "asset substitution" conflict between debt and equity that is analogous to the conflict described here, see Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 473 (1992).

managerial misbehavior such as a change in managerial fiduciary duties as companies reach the zone of insolvency.<sup>105</sup> Within bankruptcy, courts should provide the protections described here.

### **3. Conflicts Between Senior Unsecured Creditors and General Unsecured Creditors**

Because senior unsecured creditors may want to provide strong incentives to managers, the availability of debt compensation will often be a positive development for senior unsecured creditors. When senior unsecured creditors do not need to provide such incentives, the opt-out mechanism described in Part V.A reduces the cost of debt compensation. Even with the opt-out mechanism, however, senior unsecured creditors will occasionally be harmed by debt compensation.

The conflicts between senior unsecured creditors and ordinary unsecured creditors parallel those between secured creditors and unsecured creditors. Unsecured creditors who are “out of the money” may grant secured creditors an extremely high percentage of their debt to encourage them to take large risks. If the risks pay off, the unsecured creditors reap much of the benefits. If the risks fail, however, then the senior unsecured creditors bear much of the cost. As explained above, unsecured creditors may be best off awarding extremely large percentage in these circumstances. Moreover, senior unsecured creditors do not enjoy some of the protections offered by the Bankruptcy Code to secured creditors.

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<sup>105</sup> See cases cited *supra* note 11.

Because of these concerns, courts should refuse to approve a debt compensation plan that has been rejected by the senior unsecured creditors when (1) there is a large amount of senior unsecured debt relative to total unsecured debt—making it more likely that senior unsecured creditors, and not general unsecured creditors, are the residual claimants of the firm *and* (2) the debt compensation amounts awarded to managers by the unsecured creditors’ committee are excessively large. These conditions indicate a heightened probability that debt compensation is being used to encourage inefficient risk taking rather than value maximization. When these conditions are not present, courts should approve debt compensation plans because they are likely to be efficient.

#### **4. Conflicts Between Equity and Unsecured Creditors**

Debt compensation may harm the interests of equity claimants in bankruptcy. Because debt compensation aligns the interests of managers with unsecured creditors, managers may favor these creditors’ interests over those of equity.<sup>106</sup> If equity holders are the true residual claimants of the firm, then the manager’s incentives to improve the value of unsecured debt may be inefficient.

These concerns should not be overstated. First, it is unlikely that equity will be the residual claimant of the firm. When equity is the residual claimant, the firm is solvent. If the firm is solvent, it is unlikely to be in bankruptcy because it should be able to meet its obligations in full.<sup>107</sup> As a result, debt compensation will only inefficiently

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<sup>106</sup> Because unsecured creditors implement debt compensation by handing a percentage of their claims to the manager, equity claimants do not bear the actual cost of debt compensation.

<sup>107</sup> Indeed, by changing the incentives of managers in bankruptcy, debt compensation serves as a useful check against opportunistic bankruptcies by solvent firms looking to use bankruptcy to alter burdensome contractual or tort obligations.

skew managerial incentives in the rare case where a solvent firm cannot find financing outside of bankruptcy to resolve a liquidity crunch.

Second, debt compensation functions as a useful corrective against the tendency of managers to have “interests closely aligned with the shareholders.”<sup>108</sup> Under debtor-in-possession rules, the manager of the bankrupt firm is commonly the pre-bankruptcy manager.<sup>109</sup> Equity appointed the manager. In addition, the manager frequently holds stock and stock options in the firm. Given this background, there is a danger that managers will unduly favor the interests of equity. Debt compensation combats this tendency. Rather than biasing bankruptcy against equity, debt compensation brings creditors rights in greater balance with those of equity.

Because of the risk that equity will be harmed by debt compensation, equity should be allowed to participate in the plan. To illustrate, suppose that the creditors’ committee of Firm grants debt compensation of 3%. If equity has the option of participating, then shareholders will have the right to grant 3% of equity to Manager. This ensures that Manager treats equity’s interest just as she treats creditors’ interests. With the option to participate in the compensation plan, equity cannot complain that its interests are harmed by debt compensation.

### ***C. Joint Administration***

Many bankruptcies are jointly administered.<sup>110</sup> When a parent company and its subsidiaries declare bankruptcy at the same time, one bankruptcy court will often “jointly

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<sup>108</sup> BAIRD, *supra* note 1, at 182.

<sup>109</sup> BAIRD, *supra* note 1, at 182.

<sup>110</sup> Insert some general reference for joint administration here.

administer” all of the bankruptcy proceedings for this group of companies. Unsecured creditors of the different entities will often have different preferences in these circumstances. For example, a holding company’s asset to liability ratio may be greater than that of its subsidiaries.<sup>111</sup> In these circumstances, the goals of the holding company’s unsecured creditors will diverge from those of the subsidiary’s creditors. Courts have recognized this problem and established a general rule that “[w]here cases are jointly administered, multiple committees may be more appropriate” to protect the divergent interests of all the creditors.<sup>112</sup>

The potential conflicts between the various groups of unsecured creditors resemble those between senior unsecured creditors and general unsecured creditors discussed *supra*.<sup>113</sup> Creditors of an entity with a large number of assets in proportion to debts may prefer not participate in a potentially expensive debt compensation plan. Creditors of less well-endowed entities may see little to lose in granting the manager an outsize percentage. Debt compensation procedures must mediate between these opposing goals.

In jointly administered cases, the committee of unsecured creditors representing the largest group of creditors by value should be entitled to devise a debt compensation plan. Other committees of unsecured creditors should be free to opt-out of this plan, just as senior unsecured creditors should be allowed to opt-out of debt compensation. If there is only one unsecured creditors’ committee,<sup>114</sup> the unsecured creditors of each entity

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<sup>111</sup> See, e.g., *In re McLean Ind., Inc.* 70 B.R. 852, 859-62 (Bankr. S.D.N.Y. 1987).

<sup>112</sup> See 7 COLLIER ON BANKRUPTCY § 1102.03[4][a] (15<sup>th</sup> ed. Revised 2004).

<sup>113</sup> See *supra* Part V.B.1.

<sup>114</sup> Even in jointly administered cases, there is no guarantee that multiple committees will be formed. See, e.g., *McLean*, 70 B.R. at 861-2.

should be allowed to opt-out of the debt compensation plan through a vote of all the unsecured creditors.

This procedure allows unsecured creditors with different goals to adopt different solutions. If the largest group of unsecured creditors holds relatively low value claims, however, then they may attempt to grant the manager a particularly large percentage and force the creditors of the other entities to either opt-out or devote an unreasonably large amount to managerial compensation. Such a plan grants the manager inefficient incentives to undertake overly risky projects.<sup>115</sup> To prevent this occurrence, the bankruptcy court should reject plans that grant the manager an overly generous percentage. An overly high percentage can be determined by comparing the proportion of debt granted to managers with the proportion of equity granted to managers in comparable firms outside of bankruptcy.

## ***D. Manager has Debt in Reorganized Company***

### **1. Problems With Debt-Holding by Managers**

In a reorganization, creditors receive claims against the reorganized company in exchange for their original claims against the firm.<sup>116</sup> The plan of reorganization divides all the creditors into different classes, with all the members of a particular class holding substantially similar claims against the bankrupt firm.<sup>117</sup> The plan of reorganization determines the structure of the new claims received by each class in exchange for the

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<sup>115</sup> For a more detailed discussion of this phenomenon, see Part V.B *supra*.

<sup>116</sup> See BAIRD, *supra* note 1, at 203 (stating that “for the prototypical Chapter 11 case, the old claims against the firm disappear with the discharge and the new obligation of the firm take their place”).

<sup>117</sup> See 11 U.S.C. § 1122(a) (2004).

original claims.<sup>118</sup> The new claims against the firm received by a class may not be the same type of claims as the original claims held by the class.<sup>119</sup> For example, some creditor classes of the original firm may receive cash for their claims.<sup>120</sup> Other classes may receive debt claims in the reorganized company in lieu of their original debt claims.<sup>121</sup> Still others may be required by the plan of reorganization to exchange their debt claims for equity claims in the reorganized entity.

With debt compensation, the manager receives a percentage of the debt of several classes. For example, if senior unsecured creditors choose to remain in the debt compensation plan, they will undoubtedly constitute a different class of creditors than general unsecured creditors. The different classes of creditors may well receive different types of claims in the reorganized firm.

To illustrate, suppose that there are two classes of unsecured creditors of Firm, class A and class B, because Firm has issued two separate series of bonds with different bond indenture contracts but otherwise identical priority levels. Both classes of unsecured creditors join in a debt compensation plan, granting Manager 3% of the face value of debt. Class A holds \$30 million in face value debt, while Class B holds \$20 million. Suppose further that Firm will have an expected value of \$35 million in reorganization. Finally, suppose that the plan of reorganization, which was confirmed, calls for Class A creditors to receive unsecured debt in the reorganized Firm with a face value of \$15 million, while class B receives equity in the reorganized Firm with an expected value of \$10 million.

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<sup>118</sup> See BAIRD, *supra* note 1, at Ch. 11 (describing the formation of a plan of reorganization).

<sup>119</sup> See, e.g., *In re Johns-Manville Corp.*, 68 BR 618, 621 (Bankr. S.D.N.Y. 1986).

<sup>120</sup> See, e.g., *id.*

Under these conditions, Manager realizes  $\$450,000 = .03 * \$15\text{m}$  in debt in the reorganized Firm (from class A) and  $\$300,000 = .03 * 10\text{m}$  in equity in the reorganized Firm (from class B) as a result of debt compensation. While this scenario works well in ensuring that Manager designs a value maximizing and non-discriminatory plan of reorganization, Manager's post-reorganization incentives are skewed. In the plan of reorganization just described, equity is the residual claimant—Firm is solvent after reorganization. Manager's decisions primarily impact equity's return, and not that of debt. Manager's fiduciary duty also lies with equity. In these circumstances, the  $\$450,000$  in debt held by Manager as a result of debt compensation constitutes a conflict of interest. Although Manager's fiduciary duty lies with equity, Manager has a pecuniary incentive to maintain the value of debt as well as equity. Consequently, Manager may be excessively cautious, choosing to forego profitable but risky investment opportunities because they create a risk that Manager's debt will decline in value. If the debt compensation plan included additional classes of creditors receiving different types of securities, then the conflicts could grow even worse.

## 2. Responses to These Concerns

As with many of the other critiques described in this Part, this concern should not be overstated. Although managerial incentives are altered when managers hold debt, this problem is not unique to bankruptcy. Almost every manager receives a salary. of salaries in bankruptcy resembles debt.<sup>122</sup> Thus, all managers suffer from split incentives—

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<sup>121</sup> See, e.g. *id.* .

<sup>122</sup> Indeed, some aspects of managerial salaries may cause even more managerial risk aversion than ordinary debt will. If the bankrupt company rejects an employment contract with its manager, the manager's damages are capped by the Bankruptcy Code. See 11 U.S.C. § 502(b)(7) (2004). To avoid

managers want to increase the value of equity to please their employers and maximize the value of their stock options; managers also strive to protect their salaries by avoiding large (but potentially favorable) risks. Awarding a manager debt in the reorganized firm through debt compensation does not create a new conflict of interest. At worst, it merely contributes to a problem that already exists.

In addition, managerial debt holding creates some positive incentives. When a manager holds debt, he is less likely to engage in inefficiently risky behavior, secure in the knowledge that the downside risks are born not by equity but rather by debtholders.<sup>123</sup> Granting a manager some debt reduces his propensity to engage in such behavior. This concern looms large in reorganized companies. Although plans of reorganization must meet convince the court that the firm will not be forced back into bankruptcy,<sup>124</sup> many once bankrupt firms wind up in chapter 11 a second time.<sup>125</sup> Granting a manager some debt reduces the likelihood of this occurrence—the manager has a selfish interest in avoiding a second bankruptcy, which would reduce the value of his debt holdings.

When the manager receives both debt and equity, he has less incentive to exaggerate the value of one security with respect to another in lobbying for the confirmation of a plan of reorganization. If creditors have greater trust in a manager, reorganization will occur more rapidly and efficiently.

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becoming constrained by this provision, managers may take low-risk decisions that minimize the risk of bankruptcy, but do not maximize value.

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<sup>124</sup> The “feasibility test” is established by 11 U.S.C. § 1129(a)(11) (2004)

<sup>125</sup> Firms that return to bankruptcy a second time are called “Chapter 22”s. For a study of Chapter 22s, see Lynn Lopucki, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a “Race to the Bottom,”* 54 *Vand. L. Rev.* 231 (2001).

### 3. Possible Modifications to Debt Compensation

In spite of all these positive incentives, post-reorganization debt-holding by the manager as a result of debt compensation should be limited for the reasons discussed above. Courts should require the manager to sell her debt claims as soon as possible. The larger and more liquid the debt market for a reorganized company's debt, the greater the speed with which the manager should be obligated to sell her debt.<sup>126</sup> This plan avoids forcing a manager to dump all of the debt immediately in fire-sale fashion, and allows the manager to search for a good price. Moreover, the price the manager receives for the debt will be a reflection of the market's (typically accurate) perception of the manager's performance during reorganization.<sup>127</sup> If the market thinks the reorganized company is in dire straits, then the manager will receive little for the debt.

This suggestion ameliorates the incentive-damaging effects of managerial debt holding after reorganization while retaining the benefits of debt compensation. Because the manager must sell her debt to the highest bidder in a market, the manager is less likely to push for a shaky plan of reorganization that leaves a high probability of a return to bankruptcy.<sup>128</sup> In addition, there is a reduced chance that debtholding will permanently dissuade a manager from necessary risk taking because the manager must sell her debt as soon as possible. While no plan is perfect, the requirement that the

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<sup>126</sup> When markets are illiquid, there is a heightened risk that a large sale by a manager would not yield the true value of the debt.

<sup>127</sup> See generally Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (explaining how capital and information markets work together in creating efficient securities prices).

<sup>128</sup> The U.S. Airways bankruptcy is one such case. U.S. Airways emerged from bankruptcy in March 2003. Just a few months later the airline had returned to its shaky financial position and filed for bankruptcy a second time on September 12, 2004. See *Key Dates in Latest U.S. Airways Bankruptcy*, <http://www.washingtonpost.com/wp-dyn/articles/A16518-2004Sep12.html>

manager sell her debt as soon as possible after reorganization enables debt compensation to proceed without overly jeopardizing the operations of the reorganized company.

### ***E. Change in Prebankruptcy Incentives***

Debt compensation also impacts pre-bankruptcy managerial incentives.<sup>129</sup> When the manager knows that she is likely to receive a portion of the firm's debt should the firm enter bankruptcy, a manager's propensity to file may increase. In addition, the manager may take a different view towards debt in the pre-bankruptcy period. Although both these developments constitute a change from the status quo, they are not necessarily negative. Indeed, they may bring some welcome changes in managers' prebankruptcy behavior.

#### **1. Debt Compensation's Impact on the Propensity to File**

Debt compensation potentially raises the total compensation received by a manager in bankruptcy.<sup>130</sup> Knowing this, a manager of a firm near bankruptcy self-interestedly prefers to file with debt compensation because of the prospect of a higher salary. This tendency may be costly. The legal and administrative costs of bankruptcy are expensive. In addition, bankruptcy sends a frightening signal to employees and other parties engaged with the firm. These parties may curtail or end their relationship with the

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<sup>129</sup> For a discussion, see Paul Povel, *Optimal 'Soft' or 'Tough' Bankruptcy Procedures*, 15 J. L., ECON. & ORG. 659 (1999). The benefit of encouraging prompt bankruptcy filings can lead to a number of counterintuitive results. See, e.g., Kenneth Ayotte & Yair Listokin, *Optimal Trust Design in Mass Tort Bankruptcy*, 7 AM. L. & ECON. REV. 403, 431-32 (2005) (finding that tort creditor priority in bankruptcy may have the perverse effect of harming rather than helping tort claimants in bankruptcy because tort creditor priority encourages managers to inefficiently delay a bankruptcy declaration).

<sup>130</sup> This need not be the case. For example, the manager's salary can be reduced to reflect the expected increase in compensation from a debt compensation award.

firm as a result of bankruptcy.<sup>131</sup> Employees with other employment options, for example, will prefer to explore those options rather than face an uncertain future with a shaky organization. By encouraging bankruptcy, debt compensation increases the frequency with which these costs will be born by the firm—an undesirable development.

Avoiding bankruptcy also has some negative effects, however. Firms in financial straits also suffer from uncertainty. A supplier of a firm with dwindling cash reserves may be reluctant to extend credit whether or not the firm has declared bankruptcy. Furthermore, a near-bankrupt firm enjoys none of the protections conferred by bankruptcy. The firm cannot obtain a stay against any creditor judgments, nor can it bring all of its claims into one forum for a rational reordering. In addition, the firm cannot take advantage of Debtor-in-Possession financing that helps reduce uncertainty for many suppliers and other parties contracting with the firm.<sup>132</sup> By encouraging bankruptcy, debt compensation reduces many of these costs.

In addition, it is not clear that debt compensation will increase the prevalence of bankruptcy to an undue degree. Debt compensation only accrues to the manager of the bankrupt firm. In many bankruptcies, the manager is fired soon after a bankruptcy declaration.<sup>133</sup> Even if the manager is not fired, the manager does not necessarily receive debt compensation. Instead, the creditors' committee makes this decision. If the creditors' committee feels that bankruptcy was unwarranted, they are unlikely to grant

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<sup>131</sup> The availability of Debtor-in-Possession financing reduces these trends by ensuring that the debtor has enough cash to maintain everyday operations. DIP financing cannot eliminate the uncertainty associated with bankruptcy, however.

<sup>132</sup> For a discussion of bankruptcy's many benefits, see BAIRD, *supra* note 1..

<sup>133</sup> In both the Enron and WorldCom bankruptcies, for example, the managers who were brought in after fraud was discovered were fired early in the bankruptcy proceedings in spite of the fact that they were unconnected to fraud. See Jeffrey Sonnenfeld, *Chief Execs Selection a Mystery to Many*, <http://www.careerjournal.com/columnists/managersjournal/20030826-managersjournal.html>.

debt compensation to the manager. Because of these considerations, the pro-bankruptcy effects of debt compensation should not be overstated.

In many ways, debt compensation's pro-bankruptcy effects are beneficial. The appeal of debt compensation in bankruptcy counterbalances the manager's fear of dismissal as a result of bankruptcy. With debt compensation in prospect, the manager will be less likely to resist an otherwise efficient bankruptcy to protect her position.

## **2. Debt Compensation's Impact on Manager's Treatment of Creditors Before Bankruptcy**

Debt compensation also changes the way managers will perceive debt as a firm approaches bankruptcy. At present, many factors align the interests of managers with those of equity.<sup>134</sup> As the firm enters the zone of insolvency, this tendency becomes inefficient. Managers take decisions to improve the interests of equity, but their decisions potentially affect creditors' interest a great deal. In particular, managers have an incentive to take on risky projects. If the projects succeed, then bankruptcy is avoided and equity benefits. If the projects fail, then creditors' claims decline in value while equity loses little.<sup>135</sup> For example, suppose that Firm has \$60 million in debt outstanding and that Firm is worth \$55 million if it continues on its present course. Manager can invest in a risky project that will either make the value of the firm \$80 million or \$20 million, each with 50% probability. The expected value of the Firm with the risk project is \$55 million. Thus, efficiency dictates that Manager should reject the risky project. From equity's perspective, however, the risky project is best. Equity receives nothing if

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<sup>134</sup> See Hall & Liebman, *supra* note 66. .

the firm continues on its present course because Firms debt obligations exceed Firm's value. By pursuing the risky project, equity's expected payoff becomes \$20 million if the project pays off ( $\$20m = \$80m - \$60m$ ) and zero if the project fails. If Manager follows equity's interests, then Manager takes an inefficient decision.

The law recognizes this danger and imposes a unique form of fiduciary duty upon officers of a firm in the zone of insolvency.<sup>136</sup> In the zone of insolvency, officers have a fiduciary duty to maximize value rather than to maximize the value of equity. This helps prevent managers from taking inefficient decisions that benefit equity but cause a greater detriment to creditors.

While the change in fiduciary duty mitigates the tendency of managers to take inefficient actions as a firm becomes insolvent, it cannot eliminate the problem. As a general matter, breach of fiduciary duty is exceedingly difficult to prove. Unless the manager has taken truly outlandish risks, the manager will have little trouble arguing that her decisions were motivated by a desire to maximize value.

Debt compensation in bankruptcy improves the incentives of managers to take efficient decisions before bankruptcy. Debt compensation accomplishes this goal by effectively granting the creditors some oversight over the manager. With debt compensation, decisions that hurt the value of debt potentially hurt the manager. Any given percentage of debt will be worth less if the manager takes inefficient decisions before bankruptcy. In addition, the manager knows that the creditors will make decisions about whether or not to adopt debt compensation, as well as the appropriate percentage

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<sup>135</sup> See cases cited *supra* note 11. Firms in the zone of insolvency, by definition, have equity that is of little value. If equity had considerable value, then the firm would not be insolvent.

award. Creditors are unlikely to award debt compensation if they feel that the manager has taken inefficient decisions in the pre-bankruptcy period. Anticipating these effects, the manager has less of an interest in engaging in the overly risky behavior that commonly characterizes the pre-bankruptcy period. Thus, debt compensation aligns the pecuniary interests of the manager with her fiduciary duties before bankruptcy as well as within it. For this reason, debt compensation's benefits extend well beyond bankruptcy.

### ***F. Cautious Implementation Should Prevent the Worst Abuses of Debt Compensation***

The previous sections examined several potential shortcomings of debt compensation. While each shortcoming can be adequately addressed, the advantages of debt compensation can only be fully obtained with competent judicial decision-making. Without such judicial capabilities, the risks identified here may transform debt compensation from a powerful new tool for managerial compensation in bankruptcy into a windfall for unscrupulous managers and creditors.<sup>137</sup>

None of the criterion suggested above for judicial approval or rejection of a debt compensation plan appears unworkable. For example, overly generous debt compensation plans should be easy to identify and reject. If the debt compensation percentage is well above the norms for incentive compensation in comparable firms outside of bankruptcy, then the debt compensation plan should be struck down. This standard should prevent the most outrageous and inefficient debt compensation plans

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<sup>136</sup> See *Pereira v. Cogan* 2003 U.S. Dist. LEXIS 7818 (S.D.N.Y. May 12, 2003). See also cases cited *supra* note 11.

from occurring. But what of debt compensation plans that appear high, but may be defensible? Such debt compensation schemes might be efficient, and it is much harder for judges to determine their value. Until bankruptcy courts have seen a number of debt compensation plans in action, it will be difficult to know whether a plan is value maximizing or not.

Because of this difficulty, bankruptcy courts should adopt a cautious stance with regards to debt compensation plans until debt compensation plans are well established. So long as judges lack experience with debt compensation plans they should reject any debt compensation plan that appears questionable, even if the debt compensation plan may be value maximizing. As judges grow more comfortable with the mechanics of debt compensation, they can expand the range of approved debt compensation plans in accord with their practiced judgment.

Cautious adoption of debt compensation offers several advantages. By allowing only modest deviations from the status quo, cautious adoption ensures that debt compensation will not engender any unforeseen disasters, allowing judges to develop some comfort with debt compensation while the stakes are reasonably low. Similarly, cautious adoption will allow judges to learn which of the potential dangers described above, if any, are relevant in practice while the costs of mistakes are at their smallest. Procedures to address any potential flaws can then be developed. Finally, cautious adoption will enable bankruptcy practitioners to grow comfortable with debt compensation.

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<sup>137</sup> Many scholars describe executive compensation more generally as windfall for unscrupulous managers. See BEBCHUK & FRIED, *supra* note 3. Even without competent judicial decision making, the chances for such an outcome should be lower in the case of debt compensation. See discussion in Part V.A *supra*.

The standards for judicial review of debt compensation articulated in this Part, combined with cautious adoption of debt compensation, should enable the realization of the considerable benefits of debt compensation at a minimum of cost and risk.

## **VI. Conclusion**

This Article proposes a new form of incentive compensation in bankruptcy that constitutes an improvement over existing compensation plans and proposals. Granting the unsecured creditors' committee the right to offer debt compensation to managers institutes much better incentives for value maximizing managerial performance. Debt compensation creates incentives for managers to self-interestedly maximize the value of the firm rather than attempt to protect their own jobs or favor one class of creditors over another. As a result, debt compensation offers a potentially important new method for improving managerial performance during bankruptcy, when managerial performance assumes a heightened importance. Debt compensation comes with some pitfalls, however. For debt compensation to realize its potential, judges must be vigilant against those attempting to abuse debt compensation for inefficient ends. This task is not intractable, however, and debt compensation's potentially prodigious benefits make the risks worth bearing.

More generally, debt compensation is an example of the potential of CEO compensation for improving bankruptcy performance. Just as scholars of solvent companies place a heavy emphasis on the role of CEO compensation in corporate governance, so too should scholarly attention in bankruptcy be redirected towards the subject of compensation.