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THE MARKET FOR CORPORATE CONTROL IN THE ZONE OF INSOLVENCY: SYMPOSIUM INTRODUCTION

Edward J. Janger[*]

Firms in financial difficulty are often targets for takeover. There are many reasons for this. The owners may be shopping the company, shopping for capital, or just trying to stay afloat. The managers may be hoping to keep their jobs. The creditors may be looking for an exit strategy. Investors may see an undervalued business that can be bought on the cheap, key asset or business synergies that can be purchased at a good price, or a competitor that can be taken off the map. These things will be true whether or not the firm has filed for bankruptcy, but if the firm files, the legal regime for both realization of value and governance changes from state corporate law to federal bankruptcy law.

For the purposes of this symposium, firms may exist in four not entirely distinct states: (1) solvent; (2) in the zone of insolvency; (3) insolvent; and (4) in a bankruptcy proceeding. Further, investors seeking to realize on the value of insolvent and nearly insolvent firms may choose: (1) liquidation; (2) a going concern sale; or (3) recapitalization. Again, all three of these scenarios can be accomplished under state law or under the Bankruptcy Code. Each regime has its strengths and weaknesses.

This symposium considers issues of governance and realization in change of control transactions of distressed firms across these legal regimes, hopefully shedding light on the regimes themselves and on their interaction.

Throughout this volume, three two-part questions recur, but each time these questions are cast in a different light:

1) How should *governance* power be allocated:
    a. *practically*—in the form of situational leverage; and
    b. *formally*—through formal decision-making authority?
2) How should enterprise *value* be allocated:
    a. by entitlement; or
    b. through *bargaining*?
3) What is the role of *process*:
    a. in assuring *transparency*; and
    b. limiting opportunistic behavior?

These questions, and the structure of this symposium, are informed by prior work of Melissa Jacoby, Edward Janger, and Adam Levitin on value allocation, governance, and the role of process in bankruptcy. This introduction will briefly describe that conceptual landscape, and then situate

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the extraordinary contributions to this volume within and without that framework.

Inside and outside of bankruptcy, entitlement and governance are inextricably linked. Debt takes priority over equity. The residual claimant, whoever they may be, bears the greatest risk, gets to make decisions, and is the beneficiary of the fiduciary duty of loyalty. However, as Dan Greenwood points out in his contribution to this symposium, this link does not matter much for solvent companies; the officers and directors simply tend to the company's business. The duty of loyalty only comes into play in cases of serious conflict or self-dealing. However, when a company nears and/or enters insolvency, questions of firm value implicate both value allocation and governance rights. The location of the residual claim is uncertain, and so is the beneficiary of the duty of loyalty. Outside of bankruptcy, there is often a mismatch. In bankruptcy, there is a wrestling match.

First, insolvency complicates governance. Creditors, trading partners, key managers, and others can take advantage of a debtor's vulnerable situation by threatening to destroy the business. *One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy*[1] considers how the liquidity of debt and modern capital markets can distort decision-making even further. Outside of bankruptcy, the liquidity of debt and equity as well as modern derivatives can create opportunities for investor opportunism. These concerns continue in bankruptcy, while in addition, a combination of supermajority voting, and the possibility of decoupling voting power and financial interest make it possible for investors to take highly leveraged short positions and use them to distort the dynamics of plan confirmation through holdout behavior.

Second, insolvency complicates questions of distributional entitlement. *Tracing Equity: Realizing and Allocating Value in Chapter 11*[2] seeks to tease apart the priorities among creditors that come into play once a company is insolvent. For solvent companies, there is a single value waterfall that flows from debt (which gets paid in full), to preferred equity (which receives a distributional priority), to common equity (which receives the residual value and voting rights). For insolvent companies, there are instead two waterfalls: one tied to assets, where the secured creditor has priority, and a second tied to the residual, unencumbered, value of the firm. This entitlement baseline establishes the parameters of bankruptcy bargaining *and* has implications for who makes decisions. Governance power should always rest with the residual claimant on the "value" rather than the "asset" waterfall.

Finally, bankruptcy law relies on certain procedural protections to address these uncertainties surrounding decision-making and distribution in

1. *See generally* Edward J. Janger & Adam J. Levitin, *One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy*, 104 IOWA L. REV. (forthcoming 2019) (discussing governance).

2. *See generally* Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673 (2018) (discussing value allocation).

insolvency. As a general rule, deviations from statutory entitlements should only occur if accompanied by consent, or compliance with the plan confirmation process. But these process protections have been under attack. *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*[3] shows how all asset sales, closed outside the context of a confirmed plan of reorganization, endanger the procedural protections designed to safeguard decisions about value maximization and protect distributional entitlements. Such quick sales potentially place too much power in the hands of asset-based claimants who may use crisis leverage to seize both governance power (control) and value. The procedural shortcut created by quick sales potentially distorts entitlements, bargaining, and governance incentives.

In short, efficient corporate control transactions in bankruptcy and insolvency can be distorted both by process and its absence. Procedural shortcuts can be used opportunistically to shut down information flows and lock-up a transaction, while procedural devices can also be used strategically to enhance the power of holdouts. The task of the symposium is to explore and untangle these competing dynamics. The two broad themes that emerge are the importance of transparency and process to ensure that value is being maximized and allocated fairly.

The first group of Articles in this symposium issue focus on information flows. Henry T. C. Hu sets forth a version of the problem focused on transparency both inside and outside of bankruptcy. He notes that it is nothing new to say that firms on the eve of bankruptcy may be lax about filing their required securities disclosure and may be factually reticent in their description of the firm's distress. However, he adds that recent tightening of requirements for class actions and for challenging the "Management's Disclosure and Analysis" section in disclosures have made this problem even worse, particularly for companies in financial distress. He then explores how the so-called "empty creditor" problem can affect information flows once the debtor has filed for bankruptcy. Jay Westbrook explores the ways in which the corporate form and jurisdictional boundaries can be used to partition assets and claims in ways that distort distributional entitlements in corporate groups. Westbrook points out that, to the extent these attributes are transparent, they can be justified, but they can also defeat legitimate expectations. He suggests a transparency-based solution, arguing for a disclosure regime that would require asset and liability partitions to be disclosed to be enforceable. Andrew Verstein continues this focus on information flows, and its role in ensuring a liquid market for businesses inside and outside of bankruptcy. He looks at insider trading law and teases out the differences in the way it applies in and out of bankruptcy.

3. *See generally* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014) (discussing process).

From disclosure and transparency, the Articles then shift to issues of governance in insolvency. Each of the Articles, in a different way, challenges the idea that traditional concepts of fiduciary duty will provide much guidance in insolvency and its vicinity. Instead, each emphasizes the importance of court supervision, process, information, and bargaining as essential safeguards. John Pottow explores the role of fiduciary duties in guiding trustees in bankruptcy. He notes that, in bankruptcy, value maximization and value distribution are often linked. When the duty to maximize value, and the duty to allocate it according to statutory entitlement conflict, fiduciary duties give no guidance. Pottow concludes that the bankruptcy process, rather than duty *per se* is what safeguards the distributive choices inherent in bankruptcy cases. Dan Greenwood carries this skepticism of traditional governance principles even further. He starts with a somewhat revolutionary suggestion, arguing that profit maximization is an inappropriate criterion for guiding corporate decision-making, and that this problem is compounded insolvency. He advocates displacing incumbent management, and instead proceeding with a trustee who would operate the company for the benefit of undiversified creditors—employees, pensioners, and sometimes suppliers. Stephen J. Lubben and Oscar Couwenberg, continue this theme, examining the various ways in which change of control transactions in bankruptcy can be used by the proponents to capture private benefits at the expense of other claimants against the estate. They suggest that since distressed debt markets are thin, the market for corporate control will not police these transactions. Finally, Janger and Levitin close the volume with a discussion of restructuring support agreements. They, like Lubben and Couwenberg, seek to find a set of principles that help identify change of control transactions that transfer private benefits. They look specifically at restructuring support agreements, otherwise known as RSAs. These are agreements entered into between creditors and sometimes the debtor prior to or during the bankruptcy case under which the parties agree to support a particular plan or reorganization. These RSAs do not solicit votes, per se, but instead contemplate that the case will proceed to a confirmed plan of reorganization. However, RSAs can sometimes operate as an end-run, limiting access to information and short circuiting process protections. Janger and Levitin identify a number of "badges of opportunism," provisions in an RSA that suggest that a proponent of the plan may be holding value maximization hostage in order to reorder the priority scheme.

The lesson of the symposium taken as a whole is that insolvency interposes a number of imperfections to the market for corporate control. Crisis gives leverage to various parties, and the power to limit information flows and extract private benefits. Attention to statutory processes can serve, when used judiciously, to increase transparency and assure the fairness of distributional choices.