THE BEARISH BANKRUPTCY

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Modern bankruptcy practice under Chapter 11 presumptively excludes the large and publicly-traded corporate debtor's shareholders from the negotiation table based on a longstanding assumption that they have no economic interest to protect because most bankrupt companies are insolvent. But bankruptcy practice overlooks a shareholder's most important economic interest: the right to enjoy the reorganized firm's unlimited upside potential after all creditor claims are satisfied. This interest, which is essentially an option right, is totally ignored in the debtor's hypothetical liquidation analysis. In a similar way, the debtor's upside potential is not fully captured by prevailing enterprise valuation techniques.

Of course, the economic uncertainties that drive companies into bankruptcy—as well as the risks that accompany most reorganization plans—also drive down the value of equity's option right. In many cases, the benefits to all other stakeholders of an efficient reorganization will far outweigh the negligible value of the upside rights. But in the case of commodity-based firms that pursue bankruptcy reorganization in declining or bearish price markets (what I call "bearish bankruptcies"), economic theory suggests that the upside potential is likely to be substantial. I argue that by excluding shareholders from the negotiation table, modern bankruptcy practice effectively severs equity's option right at the outset of the case. Then, bearish

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debtor use a variety of complex and understudied commercial instruments to eliminate uncertainty and convert, in the earliest days of the case and with minimal judicial oversight, certain creditors' limited and fixed rights into unlimited upside rights.
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I. INTRODUCTION

At 11:00 a.m. on Friday, September 2, 2016, shareholders from every walk of life filed into Judge Christopher Sontchi’s courtroom on the fifth floor of the red brick building housing the U.S. Bankruptcy Court for the District of Delaware. They came to hear the court’s decision about whether to confirm a corporate debtor’s proposed restructuring plan that would extinguish existing equity interests and transfer the company to certain creditors.1 Between the regular courtroom and an overflow recess, several hundred people were in attendance. Approximately half were individual common shareholders of the large, publicly-traded debtor company.2 Other equity holders joined telephonically, dialing in from places as far away as Hong Kong.3

Even for one of the country’s busiest bankruptcy venues,4 it was an exceptional turnout for a plan confirmation hearing. Meanwhile, some of the country’s most respected financial news reporters were already covering the case.5 By all accounts, this Chapter 11 case unfolding just a few blocks from the Delaware Court of Chancery—the country’s leading referee of disputes

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2 E-mail from Guy Spier, Founder and Managing Partner of Aquamarine Capital, to author (Sept. 14, 2016, 11:32 EST) (on file with the author).
3 Town, supra note 1.
4 Most cases involving publicly-traded debtor companies are filed in the District of Delaware or the Southern District of New York. See Laura Napoli Coordes, The Geography of Bankruptcy, 68 VAND. L. REV. 381, 389 (2015) (“[T]he number of bankruptcy cases in these two jurisdictions is staggering: as of 2011, seventy percent of the largest two-hundred public-company filings since 2005 had been handled in either New York City or Delaware.”); Theodore Eisenberg & Lynn M. LoPucki, Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations, 84 CORNELL L. REV. 967, 972 (1999) (noting that forum shopping for bankruptcy courts has been focused on Delaware and New York).
between and among corporate stakeholders—was poised to offer a well-fought victory for the growing legions of shareholders who intervene in large Chapter 11 cases to protect their interests.\(^6\)

The debtor in possession—zinc producer and metal recycler Horsehead Holding Corp., a Delaware corporation (Horsehead Holding)—was an otherwise obscure company doing business in a non-public-facing industry. But the case had captured Wall Street’s attention months earlier when, notwithstanding the debtor’s insistence that it was hopelessly insolvent and that its shareholders had no economic interest in the case, Zurich-based fund manager Guy Spier delivered an impassioned pro se plea to the court to order the U.S. Trustee to appoint an official equity committee to advocate on behalf of shareholders.\(^7\) Spier and other investors pointed to the company’s audited financial statements, which disclosed assets of

\(^{6}\) See Alana Semuels, *The Tiny State Whose Laws Affect Workers Everywhere*, *The Atlantic* (Oct. 3, 2016), https://www.theatlantic.com/business/archive/2016/10/corporate-governance/502487/ ("[T]he reason that corporations want to incorporate in Delaware is so that their disputes will be heard by one of the five judges of the state’s Court of Chancery . . . .").

\(^{7}\) Shareholders of Chapter 11 debtor companies increasingly attempt to come together to gain influence in the proceedings. See Diane Lourdes Dick, *Grassroots Shareholder Activism in Large Commercial Bankruptcies*, 40 J. CORP. L. 1, 2 (2014) (noting that “individual shareholders of large and distressed publicly traded corporations in Chapter 11 bankruptcy have increasingly engaged in direct action and grassroots organization in their efforts to influence the restructuring” (footnote omitted)). For recent developments in leading cases, see Ana Lucia Hurtado, *The Equity Committee Trend: When Shareholders of a Bankrupt Company Hope to Get More Than Nothing*, *Forbes* (Oct. 14, 2016), https://www.forbes.com/sites/maxfrumes/2016/10/14/the-equity-committee-trend-when-shareholders-of-a-bankrupt-company-hope-to-get-more-than-noting/#6d8974d056b2.


\(^{9}\) Voluntary Petition for Non-Individuals Filing for Bankruptcy at 1, 6–7, *In re Horsehead Holding Corp.*, No. 16-10287 (Bankr. D. Del. Feb. 2, 2016). Unless the context indicates otherwise, references in this Article to “Horsehead Holding” and to the “company” refer to Horsehead Holding Corp., and its debtor affiliates, together.


\(^{11}\) Transcript of Hearing at 6, *In re Horsehead Holding Corp.*, No. 16-10287 (Bankr. D. Del. May 2, 2016) (on file with the author).
approximately $1 billion\textsuperscript{12} and stockholders' equity of $434 million,\textsuperscript{13} as well as more recent unaudited financial data reflecting equity of $458 million.\textsuperscript{14} They claimed that the bankruptcy was the unfortunate consequence of the company's technical default under a relatively small line of credit, and that it was a robust enterprise with supportive shareholders.\textsuperscript{15}

For its part, the debtor insisted that its previously-released financial statements were woefully out of date.\textsuperscript{16} But if financial conditions had deteriorated so much, the company had made little effort to communicate these changes to shareholders. The company had failed to timely file its Form 10-K, with corporate officers explaining in a Securities & Exchange Commission filing that,

\begin{quote}
[a]s a result of the Company's position prior to and after filing for Chapter 11 . . . the Company has been unable to dedicate financial and human resources to the preparation of the Annual Report and has determined that it is unable to timely file its Annual Report without unreasonable effort or expense.\textsuperscript{17}
\end{quote}

Nonetheless, the company dedicated substantial financial and human resources to resisting formation of an official equity committee\textsuperscript{18} and to fast-tracking a plan of reorganization that would take the company private.\textsuperscript{19}

\textsuperscript{12} Voluntary Petition for Non-Individuals Filing for Bankruptcy, supra note 9, at 6.
\textsuperscript{13} Horsehead Holding Corp., Annual Report (Form 10-K) 36 (Mar. 2, 2015).
\textsuperscript{14} Id. at 63.
\textsuperscript{15} See, e.g., Rupert Hargreaves, Horsehead Holdings: A Failure of Capital Markets?, VALUEWALK (Jan. 9, 2017), https://www.valuewalk.com/2017/01/horsehead-holdings-guy-spie/ (noting that two shareholders had indicated they were willing to finance the company during hard times).
\textsuperscript{16} Debtors' Omnibus Objection to Motions for Appointment of an Official Committee of Equity Security Holders at 10, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Apr. 25, 2016) [hereinafter Debtors' Omnibus Objection].
\textsuperscript{17} Horsehead Holding Corp., Notification of Late Filing (Form 12b-25) 3 (Mar. 1, 2016).
\textsuperscript{18} See generally Debtors' Omnibus Objection, supra note 16 (resisting formation of an official equity committee on the grounds that the company was hopelessly insolvent, making such a committee unnecessary and an inefficient use of the estate's scarce resources).
\textsuperscript{19} See Debtors' Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 22, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Apr. 13, 2016) ("[A]ll Existing Interests shall be cancelled without any distribution on account of such Interests.").
In support of the draft plan proposing a debt-to-equity swap, the debtors released an enterprise valuation analysis positing that the reorganized company would be worth somewhere in the range of $255 million to $305 million—an amount that, if accurate, would mean that the company was deeply insolvent. And yet, notwithstanding the gravity of such a revelation for shareholders and many classes of creditors, the company conceded that, in preparing this estimate and the separate hypothetical liquidation analysis, “no independent valuations or appraisals of the Debtors were sought or obtained.”

If shareholders had any hope of defending their interests, they needed to do so during the Chapter 11 case. For one thing, a prevailing equitable mootness doctrine makes Chapter 11 plans virtually non-appealable once confirmed. And, although the debtors’ alleged deterioration in value hinted at viable causes of action against management, the debtors proposed broad litigation releases that would have effectively foreclosed any such lawsuits. For all practical purposes, it was now or never, and the shareholders needed an official committee to lodge an effective defense.

But the U.S. Trustee, evidencing a great deal of faith in the debtors’ claims of hopeless insolvency, refused to use its discretion

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21 See id. at Ex. C (providing a detailed liquidation analysis of the company).

22 Id. at Ex. D.

23 Such was the experience of shareholders of Allied Nevada Gold Corp., who launched an unsuccessful pro se appeal of the bankruptcy court’s decision to confirm a reorganization plan. See In re Allied Nevada Gold Corp., 565 B.R. 75, 84 (D. Del. 2016) (applying the equitable mootness doctrine in refusing to decide the appeal because the reorganization plan was “substantially consummated”).


25 References herein to the “U.S. Trustee” mean the relevant regional office of the U.S. Trustee Program. In In re Horsehead Holding Corp., this means the U.S. Trustee for Region 3, which includes Delaware. United States Trustee’s Response to Motions of Guy
to appoint an official equity committee.26 And so, in a last-ditch effort, Spier, a self-described follower of Warren Buffet’s value investing strategy and a firm believer in the company’s intrinsic value,27 filed a pro se motion requesting that the court order the appointment of an official equity committee.28 The debtors,29 the senior secured creditors,30 the unsecured creditors committee,31 and even the U.S. Trustee32 opposed Spier’s motion. At a May 2016 hearing, Spier delivered stirring testimony on behalf of himself and hundreds of individual shareholders from around the world who filed joinders to his motion.33 The bankruptcy court acknowledged that the case raised serious fairness concerns and agreed that shareholders needed an official committee to adequately represent them: “[t]o put it bluntly, something doesn’t smell right to the Court.”34 That decision should have signaled to


26 See generally Docket Sheet, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Feb. 2, 2016) (showing no filing by the U.S. Trustee regarding an official equity committee until Spier motioned for one’s appointment).


28 See Pro Se Motion for the Entry of an Order Appointing an Equity Committee at 6, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Mar. 23, 2016) (“I respectfully submit that appointing an equity committee would go a long way towards redressing the enormous imbalance of power that exists within this case.”).

29 Debtors’ Omnibus Objection, supra note 16.


31 Statement of the Official Committee of Unsecured Creditors in Response to Motions Seeking the Entry of an Order Directing Appointment of an Equity Committee at 4, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Apr. 25, 2016) (“[T]he Committee respectfully submits that Movants have not met their burden. The appointment of an equity committee in these Cases is not appropriate at this time.”).

32 United States Trustee’s Response to Motions of Guy Spier and Phillip Town for Appointment of Equity Committee, supra note 25, at 7 (“The Movants have not met their burden to prove the necessity or appropriateness of an official committee of equity security holders.”).


34 Id. at 100–01.
all participants and observers that the case would chart an extraordinary course.

*Horsehead* lived up to its potential, leading Judge Sontchi to remark at the September plan confirmation hearing that his decision to confirm the debtors' plan was “one of the most difficult decisions I've had to make in ten years on the bench and one of the closest calls that I've had to make.” Rejecting accusations by shareholders that the plan was not proposed in good faith because the debtor had declined to put forth its best efforts toward marketing and selling the company, Judge Sontchi reiterated a foundational principle of corporate bankruptcy reorganization: a debtor is not required to auction itself to the highest bidder, and may focus its efforts on negotiating a debt-to-equity swap with its existing creditors. Nonetheless, to be confirmed, a Chapter 11 plan must meet statutory requirements intended to safeguard the interests of junior stakeholders. Because the debtors' proposed plan would cancel existing equity interests for no consideration, the plan needed to be “fair and equitable” to shareholders. This means that under the plan, senior claimants must not receive more than they are entitled to receive, thereby siphoning value that would otherwise flow to equity holders. Judge Sontchi explained: “If I'm going to confirm this plan, I have to make a finding that it's more likely than not equity is out of the money. If I can't figure that out, if it's a tie, or if equity's thesis is more likely, then the plan can't be confirmed.”

Characterizing the case as a “battle of the experts on valuation,” Judge Sontchi—himself an author of at least one paper on valuation methodologies—meticulously critiqued the debtor's and the equity committee's expert testimony. After making adjustments, Judge Sontchi arrived at an enterprise value

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36 See id. at 9.
38 Id. § 1129(b).
39 See id. § 1129(b)(2) (explaining the requirements for a plan to be considered “fair and equitable”).
41 Id. at 7.
of $653 million—a figure that he acknowledged was “roughly equivalent to the 650 million dollars in claims”—placing shareholders “at the very least, on the cusp of being in the money.” Yet Judge Sontchi still confirmed the plan and permitted the debt-to-equity swap on the grounds that shareholders had another hurdle to overcome: “the 85 to 100 million dollars of new capital that’s going to be required” to repair and revive the company’s idled plant, and which was promised pursuant to new equity funding agreements between the debtor and its senior creditors. The court concluded that this “new money” was pivotal to the reorganization and “ha[d] to come from somewhere.” In other words, although the court momentarily acknowledged that the company may be solvent, a future capital infusion that shareholders were not invited to participate in would be the linchpin.

As a technical matter, then, the case did not come down to a battle of the experts on valuation, and it demands more from commentators than the usual hand-wrangling about the challenges of valuing companies in Chapter 11. Spier, who served as chair of the official equity committee, believed that the company was worth far more than the debtor surmised. He ventured that, as commodities prices recovered and the plant revived, the company would be worth $1.5 billion within five years. This is why Spier, like so many other shareholders, was not simply fighting for the right to share in an immediate distribution of residual value. Just as importantly, or even more so, he was fighting to retain the right to enjoy the reorganized company’s upside.

Spier and other shareholders imagined ways to maintain equity’s optionality, making creditors whole while still preserving a stake in any future excess value. For instance, the debtor might

43 Transcript of Ruling on Confirmation Hearing, supra note 35, at 16.
44 Id.
45 Id.
46 In the confirmation order, the court declared that the company was insolvent, presumably based on a tally that included existing claims and the promised capital infusion. Findings of Fact, Conclusions of Law, and Order Confirming Debtors’ Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 13, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Sept. 9, 2016).
have avoided bankruptcy altogether by conducting a rights issue to raise needed capital from the equity markets.\textsuperscript{48} And within bankruptcy, the company could have pursued a plan that would have either left common shares intact and issued preferred shares to creditors, or allowed existing equity owners to receive shares in the reorganized company if the stock price were to trade above a predetermined threshold by some future date. If it was intent on taking the company private, the debtor could have auctioned itself to the highest bidder and distributed the proceeds to stakeholders.\textsuperscript{49} But practically speaking, these possibilities were never on the table. Pursuant to agreements executed in the earliest days of the case, the debtor had promised its senior creditors that it would work quickly towards finalizing a plan that was acceptable to them, and that it would not "solicit or engage in any discussions with third parties regarding an Alternative Transaction."\textsuperscript{50} And these senior creditors pressed for a plan that would give them ownership of the company.\textsuperscript{51}

Lamenting the court’s decision to confirm the plan, Spier acknowledged, “[w]e were not in a position to put the system on trial.”\textsuperscript{52} Indeed, that would be a tall order for any party to a large and fast-tracked Chapter 11 case. But legal scholarship does not face the same limitations and has the potential to support the pursuit of justice through critical reflections on law and legal practice.\textsuperscript{53} In that spirit, this Article takes up the baton, shedding new light on the legal and historical underpinnings of bankruptcy

\textsuperscript{48} Guy Spier repeatedly urged the debtor to conduct a rights issue. See, e.g., Transcript of Hearing, supra note 11, at 31–32, 38.

\textsuperscript{49} See, e.g., Bruce A. Markell, The Case Against Breakup Fees in Bankruptcy, 66 Am. Bankr. L.J. 349, 364 (1992) ("[A]uctions are typically used to rank bidders and to award the assets to the bidder with the highest valuation.").

\textsuperscript{50} See Interim Order (A) Authorizing The Debtors to Obtain Postpetition Secured Financing Pursuant to Section 364 of the Bankruptcy Code, (B) Authorizing the Debtors to Use Cash Collateral, (C) Granting Adequate Protection to the Prepetition Secured Parties, (D) Scheduling a Final Hearing, and (E) Granting Related Relief Ex. 1 at 57, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Feb. 4, 2016) [hereinafter Interim Order]; Horsehead Holding Corp., Current Report (Form 8K) 2 (July 11, 2016).

\textsuperscript{51} See Morgenson, supra note 5 (noting that "the company’s dominant creditors . . . typically drive the bankruptcy process").

\textsuperscript{52} Hals, supra note 47.

reorganization under Chapter 11. I argue—as I have elsewhere—that Chapter 11 fails to adequately protect shareholders. But this work explores more fully the consequences of that failure with respect to commodity-based firms that enter bankruptcy in declining or bearish price markets (what I call "bearish bankruptcies"). Equity holders are normally the only stakeholders with a preexisting right to the debtor’s unlimited upside potential after all creditor claims are satisfied, but bankruptcy law’s failure to protect them means that this potentially valuable right is left vulnerable. And nowhere is this right more coveted than in the bearish bankruptcy reorganization, where prevailing economic theory provides at least some assurance that the debtor’s business is only temporarily suppressed.

This Article proceeds as follows. Part II introduces the bearish bankruptcy reorganization and the unique challenges of valuing a commodity-based firm using prevailing corporate valuation techniques. Part III explores the relationship between a Chapter 11 debtor and the equity owners who normally lay claim to its unlimited upside after all creditor claims are satisfied. Part IV examines the relationship between a corporate debtor and its dominant creditors, and also explores the ways in which parties use certain devices and instruments in Chapter 11 to reallocate upside rights. Part V investigates various reforms that may help to restore fairness to bearish bankruptcy reorganizations. Part VI concludes.

II. BEARISH BANKRUPTCY EXCEPTIONALISM

In recent years, in addition to the usual roster of failed companies and struggling retailers, so-called commodity-based firms—meaning companies with the majority of their earnings exposed to commodity prices—have dominated most listings of large Chapter 11 filings. For example, in addition to Horsehead

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54 See generally Dick, supra note 7.
56 By “large,” I mean those cases that come within the definition of “mega-cases” used by the Administrative Office of the U.S. courts:
Holding, numerous mining companies, oil producers, oil services providers, natural gas processors, and even a cocoa producer have recently submitted to the jurisdiction of the U.S. bankruptcy courts during periods of major contraction in their relevant commodities markets.

To explain the large number of commodity-based filings, most observers cite the consistently inverse relationship between the U.S. dollar and commodity prices. As the U.S. dollar began to strengthen in 2014, it pushed global commodity prices extremely large case[s] with: (1) at least 1,000 creditors; (2) $100 million or more in assets; (3) a great amount of court activity as evidenced by a large number of docket entries; (4) a large number of attorneys who have made an appearance of record; and (5) regional and/or national media attention.


See Chris Martin, SunEdison Joins Crowded List of Commodity Bankruptcies This Year, BLOOMBERG TECHNOLOGY (Apr. 21, 2016, 9:57 AM), https://Bloomberg.com/news/articles/2016-04-21/sunedison-joins-crowded-list-of-commodity-bankruptcies-this-year (providing a list of U.S. restructurings in 2016 and noting that the list is dominated by energy and commodity companies).


Then, in each specific commodity market, other forces—such as oversupply and diminished demand—have further contributed to financial distress. Although some large companies enter into multiyear sales agreements, swap agreements, and other hedging arrangements to protect against fluctuations in commodities prices, these contracts often provide only partial protection, mitigating but not eliminating the effects of global price declines. And, of course, many commodity-based firms choose not to hedge price risks in their primary commodities markets, as shareholders usually desire exposure to the natural price fluctuations.

In declarations explaining their reasons for seeking bankruptcy protection, commodity-based debtors typically cite the decline in prices and the general uncertainty and volatility in their relevant commodities markets. They explain how these macroeconomic pressures, when combined with high debt loads, contribute to declining revenues from operations, difficulty effectuating asset
sales,69 and other liquidity challenges.70 There is no question that these market realities have the potential to cause severe firm-level financial distress. At the same time, though, these commodity-based filings (what I call “bearish bankruptcies”) must be distinguished from commercial bankruptcies that are caused primarily by financial scandal, ill-fated strategic choices, and other ongoing operational challenges, such as obsolete business models.71 This is because, notwithstanding the very real near-term financial challenges caused by downward price pressures, commodities markets are generally cyclical in nature. Although longer-term shifts may occur in particular markets, analysts generally predict that commodity prices will stabilize and even rise again in the future.72 Professor Eduardo Schwartz explained the tendency for commodities markets to self-correct thusly:

In an equilibrium setting we would expect that when prices are relatively high, supply will increase since higher cost producers of the commodity will enter the market putting a downward pressure on prices. Conversely, when prices are relatively low, supply will

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69 See, e.g., Declaration of Michael Magilton, supra note 66, at 4 (“The decline in the price of oil and natural gas has also affected the Company’s ability to effectuate certain asset sales...”).
70 See, e.g., Declaration of Dale W. Boyles in Support of Chapter 11 Petitions and First Day Motions at 18, In re Noranda Aluminum Holding Corp., No. 16-10083 (Bankr. E.D. Mo. Feb. 8, 2016) (“[T]he sustained decline in aluminum prices has only intensified the pressure on the Debtors’ business and capital structure. This has made maintaining acceptable levels of liquidity impossible.”).
71 Recent bankruptcy law scholarship explores these and other subcategories of Chapter 11 filings. See generally, e.g., Kara J. Bruce, Rehabilitating Bankruptcy Reform, 13 NEV. L.J. 174 (2012) (examining the impact of recent amendments to the Bankruptcy Code through the lens of retailer debtor companies); Melissa B. Jacoby & Edward J. Janger, Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy, 123 YALE L.J. 862 (2014) (examining bankruptcy cases involving debtors that are so distressed that they “melt like ice cubes,” burning through more cash than they earn each day).
decrease since some of the higher cost producers will exit the market, putting upward pressure on prices.\textsuperscript{73}

Of course, bankruptcy is one of the primary ways in which some higher cost producers exit the market. However, to the extent a bearish debtor uses bankruptcy to reorganize rather than liquidate a commodity-based firm, it has chosen to remain in the market. Naturally, the decision to reorganize rather than liquidate a distressed firm should not be made lightly. As a fiduciary, the debtor is required to act in the best interests of all stakeholders, and must not chase highly uncertain long-term cash flows at the expense of creditors who shoulder the risk of plan failure. At the same time, though, the bearish debtor that has chosen to reorganize has likely taken into consideration the cyclical nature of its business. Assuming that the decision was based on an assessment that the upside potential outweighs the risks and uncertainties, then the bearish debtor should be expected to accurately value and fairly allocate the upside rights.

One complicating factor is that the debtor has wide latitude to exercise its fiduciary duties as a bankruptcy case unfolds,\textsuperscript{74} and courts show great deference to its business judgment\textsuperscript{75} and to the


\textsuperscript{74}Professor Lubben reminds us that although corporate debtors have ample discretion to make decisions in bankruptcy, their actions are nonetheless governed by corporate fiduciary duty law. Thus, many of the perceived problems in bankruptcy process are actually failures of non-bankruptcy corporate law. See Stephen J. Lubben, The Board’s Duty to Keep its Options Open, 2015 U. ILL. L. REV. 817, 818 ("[I]f the tendency for debtors to show up in chapter 11 with no option but to engage in a quick sale process is a problem, that problem has its roots in nonbankruptcy corporate law."). The problems identified in this Article certainly suggest a breakdown in corporate fiduciary duties; however, modern bankruptcy process seems to be a contributing factor.

\textsuperscript{75}“The business judgment rule ‘is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company.’” Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Resources, Inc.), 147 B.R. 650, 656 (S.D.N.Y. 1992) (quoting Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)). In Chapter 11, the business judgment rule manifests as a presumption that the debtor’s decisions are reasonable. See, e.g., Comm. of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (In re Johns-Manville Corp.), 60 B.R. 612, 615–16 (Bankr. S.D.N.Y. 1986) ("[T]he Code favors the continued operation of a business by a debtor and a presumption of reasonableness attaches to a debtor’s management decisions."); In re Simasko Prod. Co., 47 B.R. 444, 449 (D. Colo. 1985) ("Business judgments should be left to the board room and not to this Court. Only
opinions of its professional advisors. The careless, rushed, colluding,\textsuperscript{76} controlled, or corrupted debtor may take advantage of these freedoms and autonomies and (1) greatly discount its own upside potential and present value; (2) use an artificially suppressed valuation estimate to argue that some creditors are taking substantial losses, while others are bearing extraordinary risks under the plan; or (3) insist that a debt-to-equity swap that vests the upside rights in certain creditors is the only fair and efficient way to restructure the company.\textsuperscript{77}

Recognizing opportunities for debtors to use their powers to prefer certain stakeholders, the drafters of the Bankruptcy Code\textsuperscript{78}—and the courts that have construed its provisions over the last forty years—have sought to check debtors' influence with important substantive protections for both senior and junior stakeholders. For instance, the established doctrine of voidable preferences allows trustees to avoid certain pre-petition transfers that violate bankruptcy's distributional priorities.\textsuperscript{79} Extensive plan confirmation requirements are designed to ensure that debtors allocate value in accordance with bankruptcy's distributional norms,\textsuperscript{80} with debtors bearing the burden of proving by a preponderance of the evidence that these requirements have been satisfied.\textsuperscript{81} And an evolving jurisprudence reminds courts to remain

\textsuperscript{76} Professor Anthony Casey highlights opportunities for collusion: "A senior creditor, exercising control over the debtor firm, determines that a bankruptcy filing to facilitate such a sale is the optimal strategy for the distressed firm. The debtor then files, and the sale is accomplished." Anthony J. Casey, The Creditors' Bargain and Option-Preservation Priority in Chapter 11, 78 U. CHI. L. REV. 759, 760 (2011).

\textsuperscript{77} Gary L. Kaplan, Understanding the Contents of a Chapter 11 Plan, LAW360 (July 30, 2013, 10:31 AM), https://www.law360.com/articles/460563/understanding-the-contents-of-a-chapter-11-plan (explaining methods for debtors to provide value to "certain constituencies" that may be "out of the money").

\textsuperscript{78} All references herein to the "Bankruptcy Code" or the "Code" are to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at Title 11 of the United States Code).

\textsuperscript{79} See 11 U.S.C. § 547 (2012) (authorizing the trustee to avoid certain pre-petition transfers); id. § 548 (setting forth the powers of a trustee to avoid fraudulent transfers).

\textsuperscript{80} See id. § 1129 (providing the requirements for confirmation of a plan).

\textsuperscript{81} See, e.g., JPMorgan Chase Bank, N.A. v. Charter Commc'n's Operating, LLC (In re Charter Commc'n's), 419 B.R. 221, 243 (Bankr. S.D.N.Y. 2009) ("As Plan proponent, [the debtor] bears of burden the establishing compliance with the factors set forth in Bankruptcy Code section 1129."); In re Genesis Health Ventures, Inc., 266 B.R. 591, 616 n.23 (Bankr. D.
on the lookout for transactions—such as sales or settlements—that are actually clever attempts by debtors to avoid these statutory checks by engaging in disguised plans of reorganization.\textsuperscript{82}

However, these substantive protections are only meaningful with respect to assets and other sources of value that can be identified and quantified by the court. The problem is that prevailing bankruptcy practice fails to fully take into account any anticipated recovery in the bearish debtor's relevant commodity market, such that the debtor's value may be greatly underestimated. Consider, for instance, hypothetical liquidation analyses. In recognition of bankruptcy's absolute priority scheme, a debtor pursuing a cramdown plan must make a showing that impaired stakeholders are not receiving less under the plan than they would be entitled to receive in a hypothetical Chapter 7 liquidation.\textsuperscript{83} But, as the name implies, this exercise is based on a liquidation scenario, without regard for future upside. Given that a bearish debtor's pursuit of a Chapter 7 bankruptcy would constitute a final exit from the market at a low point in the relevant commodities market, the utility of this exercise for bearish bankruptcy reorganizations seems questionable. Because the exercise assumes that the debtor will be dissolved, it also assumes away the value of equity's option right.\textsuperscript{84} And yet, in a reorganization, the debtor is clearly choosing to remain in the market—likely because it places a high value on the upside potential that the exercise demands we ignore.

Moreover, the exercise may even artificially suppress liquidation values. Liquidation analyses are asset-based valuations; however, debtors do not actually conduct appraisals. Instead, they typically base the exercise on book values as disclosed in the most recent

\textsuperscript{82} See infra Part IV.

\textsuperscript{83} See 11 U.S.C. § 1129(b)(2)(C)(i). For instance, equity security holders must receive or retain "property of a value, as of the plan's effective date, equal to the greatest of": (1) "any fixed liquidation preference"; (2) "any fixed redemption price"; or (3) "the value of such interest." \textit{Id.}

\textsuperscript{84} In a similar way, hypothetical liquidation analyses exclude the debtor's valuable tax attributes. See Diane Lourdes Dick, \textit{Bankruptcy's Corporate Tax Loophole}, 82 FORDHAM L. REV. 2273, 2302 (2014) ("Testing the Chapter 11 plan against a hypothetical liquidation naturally omits the debtor's valuable tax attributes from consideration, as they would be extinguished when the liquidated debtor is subsequently dissolved.").
audited financial statements, with adjustments made to approximate less than optimal sales conditions. But financial statements prepared in accordance with GAAP suffer from a number of limitations, including that they reflect norms and conventions that are designed to prevent the overstatement of corporate earnings. Under a prevailing convention of conservatism, GAAP directs companies to anticipate and disclose potential future losses rather than identify and estimate potential future gains. For instance, the value of inventory—including a commodity-based firm's stockpiles—should be reported at the "lower of cost and net realizable value." This means that a commodity-based firm may be required to take impairment charges in periods of declining commodity prices; however, the rules do not similarly permit it to increase the reported value in periods of rising prices. Financial statements also do not capture the value of a company's (or a strategic investor's) rational decision to postpone sales until prices stabilize, and may not even capture the value of a company's hedging strategies.

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85 Some of these limitations are empirically examined in Baruch Lev & Feng Gu, The End of Accounting and the Path Forward for Investors and Managers (2016).
86 Of course, even then, financial statements may still be fraudulent or misleading. See generally Howard M. Schilit & Jeremy Perler, Financial Shenanigans (3d ed. 2010) (analyzing manipulations in earnings, cash flow, and key metrics).
87 On conservatism as a basic accounting principle, see Thomas R. Ittelson, Financial Statements 12 (rev. & expanded ed. 2009) ("Accountants have a downward measurement bias, preferring understatement to overvaluation."). On the theoretical rationale for a conservative bias, see Young K. Kwon, Accounting Conservatism and Managerial Incentives, 51 Mgmt. Sci. 1626, 1626 (2005) (suggesting that "conservative accounting enhances the incentive value of accounting signals with respect to... agency costs"); Young K. Kwon et al., The Demand for Accounting Conservatism for Management Control, 6 Rev. Acct. Stud. 29, 29 (2001) (introducing a new rationale for conservative accounting, one based on the idea that "the principal designs the accounting system to be biased conservatively in order to efficiently motivate the agent").
88 CODIFICATION OF FINANCIAL ACCOUNTING STANDARDS, Accounting Standards Update No. 2015-11, at 1 (Fin. Accounting Standards Bd. 2015).
89 Id. For a theoretical analysis of impairment rules, see Robert F. Göx & Alfred Wagenhofer, Optimal Impairment Rules, 46 J. Acct. & Econ. 2 (2009).
Similarly, the methods that are traditionally used to measure the debtor's enterprise value—which, in theory, should reflect the reorganized company's expected growth potential—may also be unreliable when applied to bearish bankruptcies. Today, enterprise value is used primarily to determine whether a plan runs afoul of the requirement that no classes of senior creditors have received value in excess of their allowed claims and at the expense of impaired junior creditors and interest holders. In a 1941 case, the Supreme Court counseled that enterprise value should be based on the reorganized company's earning capacity rather than underlying asset values. It is interesting to note that at the time of the Court's decision, in contrast to modern bankruptcy practice, enterprise value was primarily analyzed to protect senior creditors rather than junior impaired stakeholders. The focus on future earnings was thought to prevent debtors from advancing plans of reorganization when the enterprise was unlikely to ever generate cash flow sufficient to pay the claims, such that senior creditors would be better served by an immediate liquidation. In situations of this sort, the debtor's use of inputs determined under conservative accounting practices would provide an additional layer of protection for creditors bearing the ultimate risk of plan failure.

But today, enterprise valuation is almost always used to show that the debtor is not transferring value to senior creditors in

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91 See Ian Ratner et al., Business Valuation and Bankruptcy 39-59 (2009) (explaining the focus on future earning capacity rather than underlying asset values).
92 See, e.g., In re Granite Broad. Corp., 369 B.R. 120, 140 (Bankr. S.D.N.Y. 2007) ("There is no dispute that a class of creditors cannot receive more than full consideration for its claims, and that excess value must be allocated to junior classes of debt or equity, as the case may be."). This concept is thoughtfully explored in Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 STAN. L. REV. 673 (2003).
93 Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941) ("The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable."). But the Supreme Court has never specified the methodology that debtors and bankruptcy courts should use to make this assessment. See Peter V. Pantaleo & Barry W. Ridings, Reorganization Value, 51 BUS. LAW. 419, 420 (1996) ("Few cases discuss in sufficient detail how reorganization value is determined and the few that do make fundamental errors in the way they either explain or apply basic valuation methodologies.").
94 See, e.g., Du Bois, 312 U.S. at 528-29 (discussing the rights of senior creditors as compared to stockholders).
95 Id. at 524-26.
excess of their claims. And in this context, the debtor's reliance on inputs determined under conservative accounting practices has the potential to lend credibility to plans that deliberately siphon value from junior stakeholders. Indeed, prevailing earnings-based corporate valuation approaches suffer from a number of limitations, particularly when applied to commodities firms. As Professor Aswath Damodaran warned, "most corporate valuations are built with the current year as the base year," and "[w]hile this fixation of the current year's numbers is always dangerous, it is doubly so with cyclical and commodity firms." This is because any such valuation will tend to overemphasize macroeconomic factors and underemphasize firm-specific characteristics. Thus, for a bearish debtor that uses the current year's financial statements as a base for its enterprise valuation, there is a danger that the analysis will overemphasize the underlying commodity's present position in its natural economic cycle.

To establish an earnings-based, unlevered enterprise value, modern bankruptcy practice generally relies on discounted cash flow (DCF) analysis to discount anticipated cash flows at the debtor's weighted average cost of capital, using the debtor's after-tax cash projections over a forecast horizon of at least five years and the anticipated terminal value of the company at the end of the period. In this way, DCF models use so-called present value

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97 See id. (noting the "volatility in earnings at cyclical and commodity firms, with macro factors at play rather than firm specific issues").

98 Enterprise valuations should be calculated on a debt-free basis in order to demonstrate the intrinsic value of the firm without regard for its capital structure.


mathematics to determine the firm's anticipated earnings, relying on the debtor's own inherently subjective input estimates.\(^{101}\)

And, despite repeated pronouncements from the country's leading corporate and bankruptcy law tribunals that DCF models should only be used when reasonably reliable inputs are available,\(^{102}\) these models continue to be used even though they are often ill-suited for bearish bankruptcies.

For one thing, DCF models notoriously fail to capture "uncertainties and opportunities"—particularly the "less certain upside."\(^{103}\) In the case of commodity-based firms, DCF models naturally include, as a key determinant of revenue, assumptions regarding cash flow from production, processing, transport, or sale of commodities at certain prices and at certain volumes. Consider the example of a company that primarily sells a commodity. Although experts agree that the market price of that commodity would be among the most important inputs in a DCF model, they disagree as to whether and how price assumptions should be adjusted to account for the commodity market's naturally cyclical nature. Some might emphasize the inherent uncertainty of future prices and recommend simply using today's prices for future cash flow projections.\(^{104}\)

But, as one business valuation expert

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\(^{101}\) For a thoughtful critique, see KEVIN J. DELANEY, STRATEGIC BANKRUPTCY: HOW CORPORATIONS AND CREDITORS USE CHAPTER 11 TO THEIR ADVANTAGE 165–67 (1992) (describing how "the valuation process can be easily manipulated").


\(^{104}\) See Christopher R. Lattanzi, Discounted Cash Flow Analysis Input Parameters and Sensitivity 6, http://web.cim.org/mes/pdf/valdaychrislattanzi.pdf ("Some commentators argue that it is futile to attempt to forecast future commodity prices and . . . that . . . valuation should be based on the assumption that today's commodity prices will persist indefinitely into the future.").
criticized, "this is tantamount to arguing that the most significant determinant of future profits is today's commodity price."\textsuperscript{105}

Although most experts agree that DCF models should make adjustments for future commodity prices, such future prices are "very difficult to predict and will differ even between professional analysts."\textsuperscript{106} Many financial analysts in the energy sector use a so-called random walk model to forecast future energy commodity prices, taking into account the anticipated rate of growth and a random deviation based on historical price movement.\textsuperscript{107} In bearish bankruptcies, debtors frequently use then-prevailing commodity futures exchange prices as the basis for DCF price inputs.\textsuperscript{108} Other debtors simply assume certain future prices without expressly disclosing how they arrived at these figures.\textsuperscript{109} Horsehead Holding, like some modern Chapter 11 debtors, did not directly disclose the future zinc and nickel prices it used; rather, it vaguely provided that it "assumed ... prices during the Projection Period generally in line with average analyst consensus estimates."\textsuperscript{110} But even slight adjustments in price assumptions can have a substantial impact on total enterprise value. In a similar way, it can be difficult for DCF models to predict the

\textsuperscript{105} Id.
\textsuperscript{110} Debtors' Second Amended Disclosure Statement, \textit{supra} note 20, at Ex. B.
volume of sales in a cyclical market, or the impact of any hedging strategies that may be available.\textsuperscript{111}

In recognition of the inherent limitations of DCF models, debtors also routinely submit enterprise value estimates derived from at least one alternative approach, with courts examining the totality of the evidence to determine the best estimation of the firm’s value as a going concern.\textsuperscript{112} A common alternative methodology is the comparable companies approach, which compares the debtor’s financial performance to those of its publicly-traded peer companies and uses valuation multiples to estimate the debtor’s enterprise value.\textsuperscript{113} Another alternative approach is the comparable transactions method, which examines recent purchase prices for comparable companies.\textsuperscript{114} But both methods suffer from many of the same limitations in the case of bearish bankruptcies, and are useful only to the extent certain adjustments are made. For one thing, peer companies are suffering through the same bear market, and have likely taken impairment charges that reflect conservative accounting practices. Adjustments must also be made to the multiples used for valuation purposes to offset the impact of bear market conditions on the peer company data.\textsuperscript{115}

Evidencing these and other limitations of prevailing corporate valuation techniques, the recent bearish debtor Arch Coal, Inc. estimated its enterprise value to be between $324 million and $666 million.\textsuperscript{116} Based on this and other evidence, the court confirmed a plan that extinguished existing

\textsuperscript{111} This critique is made in Aminul Haque et al., Estimation of Mining Project Values Through Real Option Valuation Using a Combination of Hedging Strategy and a Mean Reversion Commodity Price, 25 NAT. RESOURCES RES. 459, 459–60 (2016) (“DCF methods often fail . . . to incorporate de-risking hedging strategies.”).

\textsuperscript{112} See, e.g., CONTESTED VALUATION IN CORPORATE BANKRUPTCY: A COLLIER MONOGRAPH, ¶ 3.03(2)(a) (Robert J. Stark et al. eds., 2011) (explaining that experts in bankruptcy cases tend to deliver a valuation range using multiple methodologies).


\textsuperscript{114} The approach is described in DONALD M. DEPAMPHILIS, Mergers, Acquisitions, and Other Restructuring Activities 263–64 (7th ed. 2014).

\textsuperscript{115} Examples are provided in ROBERT A.G. MONKS & ALEXANDRA REED LAJOUX, CORPORATE VALUATION FOR PORTFOLIO INVESTMENT 275–79 (2011).

equity for no consideration and transferred ownership to certain creditors.\textsuperscript{117} However, upon exiting bankruptcy, the publicly-traded stock of the reorganized company soon traded at more than $70 per share,\textsuperscript{118} representing a market capitalization of more than $1.7 billion.\textsuperscript{119} The stunning discrepancy highlights the disconnect between valuation estimates and market-based assessments—the latter likely takes into account the upside potential that the former so poorly reflects.

In Chapter 11, prevailing corporate valuation approaches are rendered even less reliable by the fact that debtors typically submit all of their financial disclosures in summary form, riddled with legal disclaimers.\textsuperscript{120} Bankruptcy courts, for their part, typically decline to conduct independent examinations.\textsuperscript{121} Instead, they show great deference to the debtor's business judgment and to the opinions of its experts, and encourage parties to negotiate to reach consensus.\textsuperscript{122} They also assume that, as a last resort, parties will litigate the matter. In this way, modern bankruptcy practice relies on parties in interest to advocate on their own behalf in order to bring admittedly imprecise financial disclosures into better alignment with the parties' own expectations regarding the company's inherent value and growth potential.

These deliberations are important in all cases, but even more so in bearish bankruptcies where it is most likely that the debtor's business is only temporarily suppressed, such that the right to the


\textsuperscript{120} On the hollowing of plan confirmation safeguards generally, see Diane Lourdes Dick, \textit{Valuation in Chapter 11 Bankruptcy: The Dangers of an Implicit Market Test}, 2017 U. ILL. L. REV. 1487.

\textsuperscript{121} See id. at 1497 (explaining how bankruptcy courts have relied on so-called implicit market tests to support non-challenged self-evaluations by the debtors because it "frees bankruptcy courts from the uncomfortable task of confirming plans on the basis of admittedly weak disclosures").

\textsuperscript{122} The tendency to rely on negotiations is examined more thoroughly in Diane Lourdes Dick, \textit{The Chapter 11 Efficiency Fallacy}, 2013 BYU L. REV. 789.
debtor's full and unlimited upside potential will be most highly coveted. The prevailing wisdom suggests that if all or even most of the stakeholders truly believe that the company is poised to make an impressive rebound, then they will negotiate—or, if necessary, litigate—for a reorganization plan that appropriately reflects and fairly allocates the upside potential.\footnote{See id. at 768 ("[Modern economic theory] asserts that persons engage in negotiation as rational actors who make decisions intended to advance self-interest.").}

In some ways, modern practice lives up to this expectation, as bearish bankruptcies tend to be highly contentious. But the theory ignores a glaring problem: as the following Part shows, the very stakeholders with preexisting rights to the debtor's unlimited upside potential after all creditor claims are satisfied—equity security holders—are routinely shut out of the deliberations and denied procedural rights that would allow them to more effectively defend their interests. In a frustratingly circular design, bankruptcy law and practice declines to fully take into account the debtor's unlimited upside potential, even though it may be a shareholder's most important economic interest. Then, it denies shareholders important procedural protections on the grounds that they have no economic interest to protect. The following Part explores these and other aspects of the debtor's relationship with its most junior stakeholders.

\section*{III. The Bearish Debtor and Its Shareholders}

When a publicly-traded company like Horsehead Holding files for Chapter 11 bankruptcy, its shareholders are understandably concerned. This is because, as a \textit{Barron's} reporter colorfully observed, "[s]hareholders usually get burned in bankruptcy court."\footnote{Bill Alpert, Shareholders Fight to Keep Peabody Stock, \textit{BARRON'S} (Jan. 14, 2017), http://www.barrons.com/articles/shareholders-fight-to-keep-peabody-stock-1484378078.} At least on the surface, the Bankruptcy Code contemplates shareholder involvement. Chapter 11's provisions on party standing provide that each and every equity security holder is a "party in interest," with a right to "raise and . . . appear and be heard on any issue."\footnote{11 U.S.C. § 1109(b) (2012).} The term "equity security holders" includes any person who holds an "equity security of the debtor,"\footnote{Id. § 101(17).} with
"equity security" meaning, in the case of corporations, shares or similar securities.\textsuperscript{127}

But while the Bankruptcy Code makes repeated reference to equity security holders, it is careful to distinguish them from "creditors," which include persons with a "claim"\textsuperscript{128} against the debtor or the debtor's estate.\textsuperscript{129} Creditors are expected to file proofs of claim to preserve their rights to payment on account of their claims, while shareholders may file proofs of interest to delineate any rights they may have to a distribution on account of their equity interests.\textsuperscript{130} The Fourth Circuit explained the importance of so cataloguing claims and interests at the outset of a case: "[T]he [Bankruptcy] Code's priority scheme requires a determination of whether a particular obligation is debt or equity."\textsuperscript{131}

Within or outside of bankruptcy, debt and equity are fundamentally different. Corporate finance theory generally recognizes that debt provides a promised, fixed return.\textsuperscript{132} This is in contrast to equity, which does not offer a guaranteed return, but rather a residual ownership stake in the firm's assets and cash flows, with unlimited upside potential.\textsuperscript{133} Consistent with these principles, state corporate law recognizes shareholders as the only residual claimants of solvent corporations; this means that in a liquidation scenario they are entitled—after the corporation's payment of all debts and other liabilities—to the corporation's residual asset value.\textsuperscript{134} Bankruptcy's absolute priority rule also

\textsuperscript{127} Id. § 101(16)(A).
\textsuperscript{128} Id. § 101(5).
\textsuperscript{129} Id. § 101(10). \textit{See also} 11 U.S.C. § 541(a) (2014) (providing that the commencement of a bankruptcy case creates an estate comprised of, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case").
\textsuperscript{131} Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (\textit{In re} Dornier Aviation (N. Am.) Inc.), 453 F.3d 225, 231 (4th Cir. 2006).
\textsuperscript{132} \textit{See}, e.g., \textsc{Steve Lumby} \& \textsc{Chris Jones}, \textsc{Corporate Finance: Theory and Practice} 397 (7th ed. 2003) (explaining that "holders or suppliers of debt capital usually receive a contractually fixed annual percentage return on their loan").
\textsuperscript{133} \textit{See id.} (explaining that equity holders become part-owners of the company and that their "annual return . . . is not contractually fixed"); \textit{see also} \textsc{Stephen A. Ross, Randolph W. Westerfield} \& \textsc{Bradford D. Jordan}, \textsc{Fundamentals of Corporate Finance} 24 (7th ed. 2006) ("Equity holders are only entitled to the residual value, the portion left after creditors are paid.").
\textsuperscript{134} \textit{See Ross, Westerfield} \& \textit{Jordan, supra} note 133, at 24 ("If the firm sells its assets and pays its debts, whatever cash is left belongs to the shareholders.").
acknowledges these fundamental differences in important ways: equity interests are always junior to creditor claims, and a Chapter 11 plan is only "fair and equitable" with respect to a dissenting class if the plan either provides for payment in full for all members of that class or if, under the plan, no holder of any junior claim or interest receives a distribution. But corporate law also recognizes shareholders as residual claimants of insolvent corporations; although their interests rank below creditor claims, such that they would not be entitled to a distribution upon liquidation of the insolvent firm, they are still owed normal fiduciary duties. This is because, to the extent the firm continues as a going concern, equity owners essentially have an option right to the firm’s future excess residual value. Unfortunately, as the previous Part explained, the value of equity’s option right is poorly reflected in prevailing corporate valuation techniques, leaving bankruptcy law to largely overlook this interest.

Of course, the Bankruptcy Code offers some procedural protections for shareholders; however, these are discretionary rather than mandatory, and an evolving jurisprudence has shifted a heavy burden of proof onto shareholders while raising the standard for granting relief. Of course, these challenges ultimately impact not only shareholders, but also unsecured creditors, who are first in line to receive any excess value and may benefit from the influence of both classes of residual stakeholders. The following sections illustrate these and related failings of modern bankruptcy law and practice.

A. INITIAL NOTICE AND INFORMATION REGARDING THE BANKRUPTCY CASE

As an initial matter, shareholders may not even receive notice of the company's bankruptcy filing as quickly as creditors receive

136 See, e.g., N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007) (noting that in these situations "creditors . . . have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties").
137 See, e.g., Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. POL. ECON. 637, 637–38 (1973) (theorizing that equity owners have call options on the corporation's assets).
notice. Of course, public companies are required to report certain material corporate events on Form 8-K, which is filed with the U.S. Securities and Exchange Commission (the SEC) and made available to the public.\footnote{See Securities and Exchange Commission, Form 8-K, Item 1.03, https://www.sec.gov/files/form8-k.pdf (requiring disclosure if a receiver is appointed or if the company becomes subject to the jurisdiction of a bankruptcy court).} A company’s filing for bankruptcy protection is a triggering event requiring disclosure on Form 8-K, and the debtor has four business days to make the requisite filing.\footnote{Id. at 2 ("Unless otherwise specified, a report is to be filed or furnished within four business days after the occurrence of the event.").} In addition, debtors are required to deliver a notice of commencement to their stakeholders, which contains important information about the decision to file for bankruptcy,\footnote{Fed. R. Bankr. P. 2002(d).} as well as such other notices that the court deems useful or necessary.\footnote{See Fed. R. Bankr. P. 2002(d) advisory committee’s note to 1983 amendment ("[T]here may be other events or matters arising in a case as to which equity security holders should receive notice. These are situations left to determination by the court.").} Such documents are typically delivered to the creditors and interest holders identified by the debtor on a master service list.\footnote{Fed. R. Bankr. P. 1007(a)(3).}

However, in the case of a publicly-traded debtor, because most equity interests are held by banks, brokers, dealer agents, and other nominees and agents, service of the notice of commencement is typically made upon these persons so that they may distribute to beneficial owners. Because the notice of commencement is often sent days or even weeks after a bankruptcy case is initiated—and individual shareholders must wait for their agents or brokers to distribute copies—shareholders will typically learn about the bankruptcy through the news rather than from direct or indirect communication from the company. Indeed, in a publication designed to provide information that every public stock investor should know about corporate bankruptcy, the SEC acknowledged this reality: “[Y]ou may first learn about a bankruptcy in the news.”\footnote{Bankruptcy: What Happens When Public Companies Go Bankrupt, SEC: Investor Publications (Feb. 3, 2009), https://www.sec.gov/representpubs/investor-publications/investorpubsbankrupt.htm.html.}
Consider, too, the § 341 meeting of the creditors,\textsuperscript{144} which must be held no fewer than twenty-one and no more than forty days after a case is filed.\textsuperscript{145} At these meetings, the U.S. Trustee provides an overview of both the Chapter 11 bankruptcy process and the particular case, and responds to questions.\textsuperscript{146} The debtor's attorneys provide important status updates and a representative of the debtor may testify under oath.\textsuperscript{147} Many observers are surprised to learn that the Bankruptcy Code provides that the U.S. Trustee may convene a similar meeting of equity security holders.\textsuperscript{148} In legislative history, Congress explained that "such a meeting would be beneficial or useful, for example, in a Chapter 11 reorganization case where it may be necessary for the equity security holders to organize in order to be able to participate in the negotiation of a plan of reorganization."\textsuperscript{149} Notes from the rulemaking advisory committee further explain that, in cases where the trustee has declined to exercise its discretion to convene a § 341(b) meeting of equity security holders, the court may order such a meeting.\textsuperscript{150} But these meetings are almost never held, and a search could not locate a single case where a bankruptcy court ordered the trustee to hold a meeting of equity security holders.

B. PARTICIPATION AND REPRESENTATION IN THE BANKRUPTCY CASE

Shareholders continue to face logistical challenges as they attempt to navigate the confusing landscape of Chapter 11 bankruptcy. These challenges are not unique to shareholders; unsecured creditors also struggle to understand their rights and obligations as parties in interest to large Chapter 11 cases. But while it has become customary practice for large corporate debtors to provide resources to assist unsecured creditors, there is no similar protocol with respect to shareholders. For instance, under federal and local bankruptcy rules, debtors in large commercial

\textsuperscript{145} FED. R. BANKR. P. 2003(a).
\textsuperscript{147} Id. at 76.
\textsuperscript{149} S. REP. NO. 95-989, at 42 (1978).
\textsuperscript{150} 11 U.S.C. § 341(b) editor’s and revisor’s notes for § 341.
cases are authorized or, at times, required to retain a so-called claims and noticing agent to provide important notices to creditors and to maintain a register of claims. While some of the agent’s services will be useful to shareholders as well as creditors, many services address only the needs of unsecured creditors. For example, agents typically establish call centers to assist creditors. Evidencing an orientation towards creditors’ needs, one of the largest claims and noticing agents advertises call center capabilities that may be “tailored to the needs of your creditor body” and staffed with agents who are “experienced at handling claims inquiries.” Without any similar support systems in place for shareholders, they struggle with many basic aspects of case participation. For instance, Chapter 11 case dockets regularly reflect proofs of claim filed by shareholders who strictly hold equity positions, and some shareholders even attempt to litigate the debtor’s routine objections to these improperly filed claims. These and other errors suggest a need for a dedicated shareholder advocate in Chapter 11 bankruptcy.

But shareholders face their greatest challenges when it comes to acquiring a seat at the bankruptcy negotiation table. Because many of the key decisions in a Chapter 11 case are reached by party consensus rather than judicial edict, it is extremely important for widely-dispersed stakeholders to come together as a collective body to negotiate with the debtor and its senior creditors. In recognition of this reality, the Bankruptcy Code directs the U.S. Trustee to form an official committee to advocate on behalf of unsecured creditors. However, the appointment of

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151 See, e.g., U.S. BANKR. CT. R. S.D.N.Y., LBR 5075-1 (indicating that the court may direct the use of agents to file court records, issue notices, maintain case dockets, and disseminate other administrative information).


153 See, e.g., Debtors’ Tenth Omnibus Objection to Disallow and Expunge Equity Interest Claims at 2, In re SunEdison, Inc., No. 16-10992 (Bankr. S.D.N.Y. June 13, 2017) (submitting an application for an order “disallowing and expunging certain proofs of claims based solely on the claimants’ purported equity ownership interest in the Debtors”).


155 Dick, supra note 122, at 766.

156 See id. at 821 (noting that “collective action confers benefits that privilege the interests of certain stakeholders over those of other stakeholders who are not able to effectively organize”).

an official committee of equity security holders is merely discretionary. Nonetheless, upon request by a party in interest, the court may order the U.S. Trustee to form an equity committee "if necessary to assure adequate representation." Of course, even without an official committee, shareholders may still mobilize and participate in the proceedings. For instance, shareholders frequently form ad hoc committees using social media and other internet platforms to overcome their collective action obstacles in order to develop litigation strategies. But without a so-called statutory committee, even well-organized shareholders do not have the same discovery powers granted to official committees. They are also not entitled to payment of professional fees and expenses from the debtor’s estate, except in those very rare instances where the court later finds that such parties have made a substantial contribution.

To understand why official equity committees are discretionary rather than mandatory under the Bankruptcy Code, it is helpful to revisit legislative deliberations concerning these and related provisions. In 1970, Congress established a nine-member Commission on the Bankruptcy Laws of the United States (the Commission) to study whether and how to amend and restate the federal bankruptcy statute that had been in effect since 1898 (the 1898 Act). Initially, Congress was concerned with "eliminating . . . economic waste" and addressing perceived weaknesses in the consumer bankruptcy laws. Later, the Senate Committee on Finance reported that the draft legislation was intended

158 Id.
160 See Dick, supra note 7, at 4, 30 (analyzing the rise of this form of shareholder activism).
161 This term is intended to distinguish ad hoc committees from those official committees formed under 11 U.S.C. § 1102.
167 See id. at 2 ("[T]he present body of laws comprising our bankruptcy system is obsolete, highly un economical, and incapable of adequately conforming to the requirements of our modern economy.").
to make bankruptcy procedures more efficient, to balance more equitably the interests of different creditors, to give greater recognition to the interests of general unsecured creditors who enjoy no priority in the distribution of the assets of the debtor's estate, and to give the debtor a less encumbered 'fresh start' after bankruptcy.\(^{168}\)

Under the 1938 amendment to the 1898 Act, three separate statutory chapters dealt with corporate reorganizations.\(^{169}\) Chapter X, which addressed large, publicly-traded corporations, contemplated the appointment of a disinterested trustee to replace the debtor's management\(^{170}\) and the submission of all reorganization plans to the SEC for review and for the issuance of an advisory report.\(^ {171}\) Indeed, the SEC played an active role in these proceedings, having explicit statutory authority to interpret and apply provisions of the 1898 Act.\(^ {172}\) Meanwhile, judicial decisions supplemented the statutory scheme with a number of special protections for creditors and shareholders. A more simplified set of rules codified in Chapter XI allowed smaller, privately-held companies to reorganize and remain in possession of the business. But a so-called "arrangement" under Chapter XI could impair only the claims of unsecured creditors, and could not affect equity security interests.\(^ {173}\) The SEC was a statutory notice party under Chapter X proceedings, and had the power to intervene to transfer cases from Chapter X to Chapter XI.\(^ {174}\) Finally, Chapter XII addressed the unique needs of individuals and businesses with debts primarily secured by real estate collateral.\(^ {175}\)

\(^ {168}\) S. REP. NO. 95-1106, at 1 (1978).


\(^ {170}\) Id. at 888.

\(^ {171}\) Id. at 890–91.

\(^ {172}\) See Eugene V. Rostow & Lloyd N. Cutler, Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act, 48 YALE L.J. 1334, 1335 (1939) (noting that "Chapter X is principally the work of the Securities and Exchange Commission").

\(^ {173}\) See id. at 1342 ("[A]rrangements under Chapter XI directly affect only unsecured debt . . . .").

\(^ {174}\) See id. at 1363 (describing how section 147 of Chapter X provides a mechanism to transfer cases improperly filed under Chapter XI to Chapter X).

\(^ {175}\) See Act of June 22, 1938, 52 Stat. at 917 (defining "debtor" for purposes of Chapter XII).
Over the 1898, and then the 1938, Act's long tenure, commercial debtors increasingly came to see Chapter X as overly burdensome and began to use the more streamlined Chapter XI.\footnote{See Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judiciary Mach. of the S. Comm. on the Judiciary, 95th Cong. 583 (1977) [hereinafter Hearings] (statement of Jack Gross, attorney, Kraus, Hirsch & Gross) (noting the "preference of lending institutions for chapter XI proceedings than chapter X proceedings").} This, in turn, led to inefficiencies and delays as parties spent considerable time litigating whether a debtor belonged in Chapter X or Chapter XI.\footnote{See id. (noting the "waste of time that goes on in the courts in determining whether a matter properly belongs in chapter X or chapter XI").} On the Commission and in Senate subcommittee hearings, heated discussion focused on whether and how to merge Chapters X, XI, and XII into a unified corporate reorganization statute.\footnote{See, e.g., id. ("The concept of one chapter to deal with the rehabilitation of distressed debtors has met universal acclaim: From debtors' counsels, institutional lenders' counsels, the national bankruptcy conference, et cetera.").} Prominent restructuring attorneys testified in favor of leaving the debtor in possession of the business, as was the case under Chapter XI, rather than requiring the appointment of a disinterested trustee, as was required under Chapter X.\footnote{See id. at 584 ("[T]he appointment of a disinterested trustee imposes on the creditors in an estate the cost of on-the-job training by, true, a disinterested trustee, but one who generally lacks the experience to conduct the business of the debtor.").} After hearing evidence from the attorneys that the debtor-in-possession model was more efficient, the presiding Senator DeConcini of Arizona asked, "Who would be appointed to represent the stockholders?"\footnote{Id. (statement of Dennis DeConcini, Sen., Ariz.).} In response, Wall Street bankruptcy attorney Jack Gross explained, "[T]hey can retain counsel and diligently pursue whatever rights they might have."\footnote{Id. at 585 (statement of Jack Gross, attorney, Kraus, Hirsch & Gross).}

Senator DeConcini seemed unconvinced and continued to advance the line of questioning. Referring back to the existing corporate reorganization statutes to help frame the problem he was identifying, he pressed further: "What does the small investor do? He cannot go and retain counsel. How does he get representation if it remains in chapter XI?"\footnote{Id. (statement of Dennis DeConcini, Sen., Ariz.).} Unfortunately, though, the Senator's reference to Chapter XI muddied the issue somewhat, as another of the testifying attorneys quickly clarified,
“The stockholders in chapter XI under the current system retain their position as stockholders. You cannot affect a stockholder in chapter XI.”183 Indeed, as Professors Walter Blum and Stanley Kaplan observed in a 1972 article, Congress’ refusal to allow nonconsensual impairment of equity interests in Chapter XI, even though it so permitted impairment of equity in Chapter X, was likely a reflection of the fact that Chapter X featured vastly more procedural safeguards, such as the appointment of a disinterested trustee and extensive involvement by the SEC.184 But the draft proposed legislation combining Chapters X and XI would have done away with this important distinction, allowing nonconsensual impairment of equity interests under a regime that also permitted the debtor to remain in possession. It seems that, at least in the subcommittee deliberation, this reality was simply overlooked.

Nonetheless, Senator DeConcini continued to express concern for shareholders. He conceded that they retain their equity interests in Chapter XI, but suggested that their most important economic interest, the right to the debtor’s unlimited upside potential, may be impaired in the long term by the debtor’s poor management: “[C]ompanies in chapter XI obviously have financial problems; and if the debtor remains in possession, then you are still operating under that management that may have caused it to be in that situation.”185 In such cases, he believed, it would be unfair to leave the shareholder “with his only recourse being his rights... as a common... stockholder.”186 He remarked, “It disturbs me that the stockholders seem to be the last to be considered, with the exception of the SEC oversight.”187 The Senator also cited the natural tendency for debtors to align with “the banks and other creditors.”188

In response, the testifying attorneys continued to advocate for a flexible approach, in which the debtor remains in possession unless the court determines that a trustee or examiner is needed.

183 Id. (statement of John J. Jerome, attorney, Milbank, Tweed, Handley & McCloy).
185 Id. at 585 (statement of Dennis DeConcini, Sen., Ariz.).
186 Id. supra note 176, at 585 (statement of Dennis DeConcini, Sen., Ariz.).
187 Id.
188 Id. at 586.
to protect any stakeholders, including equity holders. And, acknowledging that shareholders need some representation, the attorneys explained that in addition to the court’s possible formation of an official equity committee, the SEC might also intervene to assist shareholders. As this and other similar exchanges in the legislative history demonstrate, Congress was sensitive to shareholder concerns and acknowledged their need for formal representation, but felt it would be more appropriate to allow multiple avenues of potential representation rather than a one-size-fits-all approach that may prove inefficient in certain cases. Hidden in the legislative history is an expectation that, in the case of publicly-traded debtor companies, the SEC would be more involved, such that mandatory official equity committees, disinterested trustees, or both, would be potentially duplicative of the agency’s efforts.

Unfortunately, modern bankruptcy law and practice have not lived up to these expectations. For the investing public, the SEC continues to serve an essential role within and outside of bankruptcy, advancing its mission “to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation... to promote a market environment that is worthy of the public’s trust.” But while Chapter 11 of the Bankruptcy Code provides that the agency “may raise and may appear and be heard on any issue in a case,” the SEC tends to concentrate its limited resources on policy and enforcement activities beyond the bankruptcy courts. In fact, in 1983, the agency made an official decision to substantially diminish its involvement in bankruptcy matters. An official statement explained,

189. Id. at 585–86 (statements of John J. Jerome, attorney, Milbank, Tweed, Hadley & McCloy; Patrick A. Murphy, attorney, Cowans & Murphy).
190. Id. at 589 (statement of Robert H. MacKinnon, attorney, Shearman & Sterling).
The conclusion that the program should be significantly curtailed was based in part on the belief that the [SEC] could reduce its own resource commitment in the reorganization area and rely on the combined efforts of the . . . U.S. Trustees and of official shareholder committees to protect the interests of the investing public.  

For the most part, the agency has continued this trend and has not often intervened in Chapter 11 cases on behalf of shareholders. With the SEC largely out of the picture, shareholders are more reliant than ever on official equity committees. Unfortunately, a jurisprudential shift in the last twenty years has made it extremely difficult for shareholders to convince courts and U.S. Trustees to exercise their discretion to appoint official equity committees. The legal standard has shifted because the phrase “adequate representation” is not defined in the Bankruptcy Code, leaving courts to assess multiple factors, such as the size and complexity of the case and the debtor’s financial condition. Reflecting an economic analysis of bankruptcy law, recent decisions from the highly influential U.S. Bankruptcy Courts for

34-27300, 54 Fed. Reg. 40,760, 40,762 (Oct. 3, 1989) ("[T]he Commission should alter then existing practices by curtailing its active participation in reorganization cases.").

195 Id.

196 It should be noted, however, that in those rare instances when the SEC does intervene on behalf of shareholders, the agency is able to deliver powerful support. For instance, in October 2016, the SEC delivered written correspondence to the U.S. Trustee advocating the formation of an official equity committee to represent shareholders of Breitburn Energy Partners LP. Addendum to Second Supplemental Response to Certain Holders of Equity Securities to Order to Show Cause Dated July 20, 2016 Why Appointment of Statutory Committee of Equity Holders Should Not Be Ordered at 2, Ex. A, In re Breitburn Energy Partners LP, No. 16-11390 (Bankr. S.D.N.Y. Oct. 7, 2016). In its letter, the SEC addressed the common misconception that shareholders do not need formal representation in Chapter 11 because they are already represented by the debtor's management. The SEC explained: “equity-owning officers and directors generally cannot adequately represent shareholders due to their conflicting fiduciary duties to creditors in a bankruptcy and other possible conflicts of interest (i.e. management incentive and retention plans).” Id. at Ex. A. At a hearing the following week, the bankruptcy court ordered the appointment of an official equity committee. Jessica DiNapoli, U.S. Bankruptcy Judge Approves Breitburn Stakeholders Committee, REUTERS (Oct. 14, 2016, 3:45 PM), http://www.reuters.com/article/breitburn-energy-equity/rpt-u-s-bankruptcy-judge-approves-breitburn-stakeholders-committee-idUSL1N1CK1MN.

197 Dick, supra note 7, at 18.

198 Id. at 18–19.
the District of Delaware and the Southern District of New York emphasize the financial burden to the estate and discourage formation of official equity committees when the debtor appears to be "hopelessly insolvent."\footnote{See, e.g., In re Williams Commc'ns Grp., Inc., 281 B.R. 216, 220 (Bankr. S.D.N.Y. 2002).}

As previous sections explored, the narrow focus on the debtor's solvency as the only way for shareholders to have an economic interest in the case reflects bankruptcy law's disregard for shareholders' most important economic interest—the right to the debtor's unlimited upside potential after all creditor claims are satisfied. To be sure, the economic uncertainties that drive companies into bankruptcy—as well as the risks that accompany most reorganization plans—also drive down the value of equity's option right. In many cases, the benefits of an efficient reorganization to all other stakeholders will far outweigh the negligible value of the upside rights. But this standard fails to take into account the unique incentives that may be present in bearish bankruptcies. In these and other cases, U.S. Trustees and bankruptcy judges across the country routinely ignore upside rights and require that shareholders requesting an equity committee bear the burden of establishing a "substantial likelihood" of the debtor's solvency.\footnote{See, e.g., In re Spansion, Inc., 421 B.R. 151, 156 (Bankr. D. Del. 2009). Courts and U.S. Trustees frequently apply the standard set forth in Exide Technologies v. Wisconsin Investment Board, No. 02-1572-SLR, 2002 WL 32332000, at *1 & n.2 (D. Del. Dec. 23, 2002), and In re Williams Communication's Group, Inc., 281 B.R. at 223.}

In practical terms, this means that shareholders must make a convincing valuation case simply to obtain a seat at the negotiation table. And they are expected to do so by subjecting evidence prepared by the debtor under conservative accounting practices to prevailing corporate valuation techniques that fail to fully capture the debtor's upside potential.

Moreover, shareholders face information asymmetries and collective action challenges that make it even more difficult for them to meet this evidentiary burden. These issues are compounded by the fact that commercial debtors frequently delay the release of audited financial statements during the pendency of the bankruptcy case, and typically include broad legal disclaimers in their financial disclosures to the bankruptcy court.\footnote{Dick, supra note 120, at 1500.}
Fortunately, the *Horsehead* court was sensitive to these concerns when it granted Guy Spier's pro se bid for an official equity committee. At the same time, though, Judge Sontchi acknowledged that the weight of modern bankruptcy law was against the shareholders: "I'm going, frankly, out on a limb here from a standpoint of where the law puts me . . . ." Although all bankruptcy judges have broad equitable powers, many have been unwilling to use their discretion to grant similar requests for official equity committees. And even when a court eventually orders the appointment of an official equity committee, the decision is usually made later in the case. Thus, shareholders may arrive at the negotiation table just in time to discover that the debtor has effectively promised away the upside rights that they have been struggling to retain.

Finally, although the U.S. Trustee is theoretically available to assist all stakeholders, the agency tends to be focused on creditor interests and economic efficiency, reflecting its mission "to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors, and the public." Under the Bankruptcy Code, the agency is charged with monitoring the administration of bankruptcy cases and taking action where appropriate to prevent undue delay. Evidencing its commitment to speed and efficiency, the U.S. Trustee almost always aligns with debtors and creditors to oppose attempts by shareholders to obtain official equity committees, typically citing the costs to the estate of providing representation to shareholders.

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202 Transcript of Hearing, *supra* note 11, at 100.
203 See 11 U.S.C. § 105(a) (2012) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").
207 See, e.g., *Statement of U.S. Trustee Regarding Emergency Motion to Appoint an Official Committee of Equity Holders at 6-7*, *In re Sandridge Energy*, Inc., No. 16-32488 (Bankr. S.D. Tex. July 25, 2016) (citing *In re Pilgrim's Pride Corp.*, 407 B.R. 211, 216 (Bankr. N.D. Tex. 2009) for the proposition that "the likely cost to Debtors' estates of an equity committee" is one factor in determining whether to appoint an equity committee).
All of this means that it can be extremely difficult for shareholders to meaningfully participate in Chapter 11 proceedings. To many modern observers, this is simply the way Chapter 11 functions; after all, state corporate laws provide that shareholders are indirectly represented in the case by the debtor's management, and shareholders are likely to be wiped out in Chapter 11. But in actuality, the drafters of the Bankruptcy Code always assumed shareholders would have some direct representation in bankruptcy, whether in the form of an official equity committee, the SEC, or a disinterested trustee—they did not expect shareholders to rely on the debtor's management or on their own expensive and often futile attempts to intervene on their own behalf. But, in their efforts to blend the previous corporate reorganization chapters in a way that would increase economic efficiency and promote flexibility, the drafters made most procedural protections for shareholders merely discretionary. Forty years later, with the bankruptcy courts, U.S. Trustee, and the SEC already stretched thin, it appears that each now looks to one or the other to guard the interests of shareholders. And it certainly does not help matters that prevailing practice ignores shareholders' most important economic interest. The following Part examines how debtors and their dominant stakeholders take advantage of these failures and seize valuable upside rights in Chapter 11.

IV. THE BEARISH DEBTOR AND ITS POSTPETITION INVESTORS

In previous sections I argue that bearish bankruptcy reorganizations present unique challenges and opportunities, and that prevailing practice systematically underestimates the debtor's value by failing to take into account the reorganized company's full upside potential. In this Part, I argue that bearish debtors and their senior creditors do not wait for plan confirmation to redistribute valuable upside rights. Rather, they take immediate steps to eliminate uncertainty and convert, early in the case, certain creditors' limited and fixed rights into unlimited upside rights. There are a variety of devices and instruments that parties

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208 Or, in the case of prepackaged plans, even before the bankruptcy petition is filed. Prepackaged plans are permissible to the extent they are solicited in accordance with 11 U.S.C. §§ 1125, 1126(b).
may use, including postpetition financing agreements and their accompanying equity participation agreements and restructuring support agreements. Taken together, these agreements effectively lock in claims to upside rights. Yet courts show great deference to debtors’ decisions to pursue arrangements of this sort, likely because of deep and longstanding judicial assumptions regarding the nature of a debtor’s relationship with its creditors generally and with its postpetition lenders in particular. The following section introduces some of the devices creditors use to secure the upside rights and how courts have traditionally viewed them.

A. POSTPETITION FINANCING ARRANGEMENTS GENERALLY

Though under-studied in academic literature, postpetition financing—including debtor-in-possession, bridge, and exit financing—is a common feature of large Chapter 11 cases. This is because it can take considerable time for a debtor to develop a Chapter 11 plan of reorganization and negotiate to obtain the support of major stakeholders. At the same time, the debtor must continue to operate its business, maintain relationships with customers and suppliers, cover payroll and satisfy working capital requirements, make any necessary capital expenditures, and manage the expenses associated with the restructuring. The debtor’s plan of reorganization may also depend on cash infusions in order to make necessary improvements or expansions. However, because all of its assets are typically leveraged at the time of a bankruptcy filing, the debtor will require special concessions—usually in the form of financing arrangements authorized by the court during the pendency of the case—to meet these liquidity needs.209

The drafters of the Bankruptcy Code sought to entice lenders to extend credit to bankrupt companies210 by including generous

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209 In addition to obtaining postpetition financing, debtors also typically request and receive permission to use cash collateral. See 11 U.S.C. § 363(c)(2) (2012) (permitting the court to authorize the use of cash collateral).

210 See 5 NORTON BANKR. L. & PRAC. 3D § 94:33 (2017) ("The purpose of Code § 364 is to induce creditors to extend credit after the commencement of the Chapter 11 case."); George G. Triantis, A Theory of the Regulation of Debtor-in-Possession Financing, 46 VAND. L. REV. 901, 902 (1993) (recounting the persistent yet dubious claim that credit enhancements are needed to induce lenders to enter into DIP financing arrangements).
credit enhancements. For instance, postpetition lenders may receive secured and/or superpriority administrative claim status, giving their claims payment priority over all other obligations of the debtor, including administrative expenses and priority claims. Postpetition lenders also customarily ask for and receive additional protections during the course of negotiations with the debtor and during the court approval process. In this way, both the statutory framework and customary practice focus on how to balance the postpetition lender's need to manage credit risk on the one hand, and the debtor's need to pursue a Chapter 11 restructuring that best advances the interests of all stakeholders on the other.

These incentives clearly empower postpetition lenders. But large commercial debtors also enjoy substantial influence. As discussed in previous sections, bankruptcy law has long recognized that debtors may use both pre and postpetition transactions to transfer value to dominant stakeholders. But postpetition financing arrangements are rarely subjected to such a high level of scrutiny. In fact, they generally escape rigorous judicial examination altogether, particularly in the jurisdictions most likely to hear large commercial cases. This is due to a fundamental assumption that collusion between debtors and their postpetition lenders is unlikely because they come to the bankruptcy negotiation table with opposing economic preferences, focus their negotiations on a specific and temporary financial accommodation, and remain antagonistic toward each other for the duration of the case.

While some commentators concede that postpetition financing agreements tend to be overly generous toward lenders, these concessions are blamed on differences in relative bargaining power

211 See 11 U.S.C. § 364 (2012) (authorizing a debtor in possession to incur postpetition debt under certain circumstances). Practitioners frequently refer to these arrangements as "debtor in possession financing" or "DIP financing."

212 Id. § 364(c).

213 See, e.g., Resolution Tr. Corp. v. Official Unsecured Creditors Comm. (In re Def. Drug Stores, Inc.), 145 B.R. 312, 316 (B.A.P. 9th Cir. 1992) ("Bankruptcy courts, however, have regularly authorized postpetition financing arrangements containing lender incentives beyond the explicit priorities and liens specified in section 364.").

214 See supra note 79 and accompanying text.

215 See infra notes 254–56 and accompanying text.

216 See infra Section IV.C.
and a legal milieu that is presently tilted too much in favor of enticing postpetition lenders. This logic suggests that, but for the debtor's weakened bargaining position, it would act on its economic impulses and drive a much harder bargain with its postpetition lenders. After all, the pursuit of financing is an exercise of the debtor's business judgment made in accordance with its fiduciary duty to maximize the value of the estate. Thus, if either party ought to be checked, it is the lender. A permissive business judgment standard is believed to provide a necessary offset: a lender can only overreach so far before the diligent, value-maximizing debtor will decide that the proposed financing arrangement would do more harm than good to the estate.

But these theoretical checks and balances may not be enough, especially in the case of bearish bankruptcies. It seems that the true risk is not what an overbearing creditor might do to restrain a weak and harried debtor, but rather what these two, independently powerful forces combined might do to bypass important safeguards and seize overlooked or vulnerable sources of value, such as upside rights. The following subsections explore these possibilities in more detail, focusing not only on postpetition debt instruments, but also on the new equity issuances that increasingly go along with them.

B. A CLOSER LOOK AT POSTPETITION FINANCING ARRANGEMENTS

Credit risk management is one of the most enduring concepts in commercial finance. Considered a nearly universal best practice among commercial lenders, the concept refers to the assessment and integration of risks pertaining to the credit relationship,

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218 See 11 U.S.C. § 1107 (2012) (noting that a debtor in possession has the same duties as a trustee); In re Washington Grp., Inc., 476 F. Supp. 246, 250 (M.D.N.C. 1979) (explaining that a trustee's duty "is to act in the best interests of the Debtors' estate").

generally with a goal of preserving liquidity and profitability.\textsuperscript{220} Financial institutions and other investors that are considering whether to lend to companies—including those in the midst of Chapter 11 bankruptcy reorganization—are assumed to base their decisions on these prevailing business standards and best practices, just as they do with any other extensions of credit.\textsuperscript{221}

Although debtors are permitted to obtain postpetition credit on an unsecured basis as an administrative expense,\textsuperscript{222} most lenders require additional assurance that an already distressed debtor will repay the obligations. Reflecting this commercial reality, the law in this area primarily serves to entice lenders to extend credit to bankrupt companies and to assist them in managing the credit risk.\textsuperscript{223} To this end, the drafters of the Bankruptcy Code expressly authorized generous credit enhancements for postpetition lenders.\textsuperscript{224} For instance, after notice and a hearing, the debtor may request that the court grant the postpetition lender administrative priority.\textsuperscript{225} Recognizing that administrative priority may not be enough of an enhancement, Congress further empowered bankruptcy courts to grant superpriority administrative claim status, thereby privileging the postpetition lender above all other priority and administrative claimants.\textsuperscript{226} When lenders demand collateral, courts are permitted to lift the automatic stay in order to grant junior liens in already-encumbered assets of the estate, or new liens in previously

\textsuperscript{220} See, e.g., BOUTEILLA & COOGAN-PUSHNER, supra note 219, at 18–19 (explaining the importance of managing credit risk).


\textsuperscript{223} See supra note 210 and accompanying text.

\textsuperscript{224} 11 U.S.C. § 364.

\textsuperscript{225} Id. § 364(c).

\textsuperscript{226} For instance, a postpetition lender who is granted superpriority administrative claim status would be granted administrative expense treatment under § 503(b)(1), taking priority over claims of the kind specified under, or ordered pursuant to §§ 105, 326, 328, 330, 331, 503(b), 507(a), 364(c)(1), 546(c), 726 or 1114 of the Bankruptcy Code. In most cases, however, the parties negotiate to allow carve-outs for certain expenses. See, e.g., In re Molycorp, Inc., 562 B.R. 67, 76 (Bankr. D. Del. 2017) ("[P]rofessionals usually negotiate a carve-out to provide for payment of their allowed fees.").
Finally, when these accommodations are still not enough to entice lenders, courts have the power to grant so-called "priming liens" on the debtor's assets pursuant to Code § 364(d). With a priming lien, the postpetition lender essentially moves to the front of the line, gaining a lien that is senior to all existing liens on the collateral.

Meanwhile, all commercial lenders—including postpetition lenders—are safeguarded by customary representations, warranties, and covenants in commercial loan documentation. With respect to postpetition lenders, even standard provisions take on greater significance, as they are typically enforceable by the case-ending remedy of terminating the loan agreement in the event of a default. Increasingly, though, postpetition lenders also ask for and receive a host of other protections, generally in the form of additional, more onerous covenants in the postpetition financing agreement. Postpetition lenders frequently request releases or waivers of claims relating to prepetition indebtedness and either cross-collateralization or "roll-up" of all or some of the prepetition debt owed to the postpetition lender. Some lenders also demand advance waivers of the debtor's most important rights (such as surcharge and avoidance actions), as well as limitations on carve-outs for payment of estate and committee professional fees. In an effort to gain "some

228 MICHAEL L. COOK & DENNIS CONNOLLY, BANKR. LITIG. MANUAL § 18.01 (2016).
229 In order to grant such a lien on already-encumbered property, the debtor must show that it cannot otherwise obtain such credit and that the interests of the existing lienholders are adequately protected. 11 U.S.C. § 364(d)(1).
230 Standard commercial financing terms are described in MICHAEL BELLUCCI & JEROME MCCUSKEY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE (2d ed. 2017), and CAROLYN E.C. PARIS, DRAFTING FOR CORPORATE FINANCE: WHAT LAW SCHOOL DOESN'T TEACH YOU (2007).
233 To avoid the enforceability issues of cross-collateralization provisions, many postpetition financing arrangements require that the debtor use some portion of the loan proceeds to satisfy certain prepetition claims, thereby "rolling up" the claims into the new, postpetition indebtedness. See Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.), 963 F.2d 1490, 1491 (11th Cir. 1992).
234 The right to surcharge a lender is set forth in 11 U.S.C. § 506(c) (2012).
measure of control over [their] investment," lenders may demand the right to appoint a CEO and/or additional members of the debtor’s board of directors. Others require that the debtor consent to so-called “drop dead” relief from the automatic stay in the event that the court confirms a plan over the lender’s objection. Increasingly, postpetition lenders require that the debtor meet certain milestones in the case, based on a detailed case timeline incorporated into the financing agreement or related instruments. These milestones may include obtaining interim and final court approval of the postpetition financing arrangement, as well as more specific milestones pertaining to asset sales or Chapter 11 plan negotiations and approval. Finally, modern postpetition financing agreements often contain market and company material adverse change and material adverse effect clauses, allowing the lender to avoid funding and renegotiate terms when market or company conditions have changed. For all of these reasons, postpetition lenders enjoy an exceptionally strong bargaining position with respect to plan negotiations.

These generous protections and enhancements are typically justified from a credit risk management perspective: they are the law’s response to the ostensibly logical question, “Who wants to lend to bankrupt companies?” But a more holistic view of

236 However, at least one bankruptcy court declined to approve a postpetition financing arrangement that included, inter alia, a provision of this sort. See In re Tenney Vill. Co., 104 B.R. 562, 568 (Bankr. D.N.H. 1989).
238 Id.
239 Material adverse change/effect clauses are discussed in a leading Delaware corporate law case. In re IBP, Inc. S'holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001).
240 Professor David Skeel summarized the concerns thusly: “The DIP loan agreement has become the single most important governance lever in many large Chapter 11 cases.” David A. Skeel, Jr., The Past, Present and Future of Debtor-in-Possession Financing, 25 CARDOZO L. REV. 1905, 1906 (2004); see also Robert K. Rasmussen, Secured Credit, Control Rights and Options, 25 CARDOZO L. REV. 1935, 1945 (2004) (“[T]he revolving credit facility lender may use the debtor-in-possession financing to increase its control.”).
241 For instance, the question has been suggested in the introduction to an article by a leading commercial restructuring attorney, Marshall S. Huebner, Debtor-in-Possession Financing, RMA J., Apr. 2005, at 30, and by the appraisal of the DIP lending relationship

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commercial financing suggests that the underlying business decision to lend to a debtor is not so controversial. In fact, the scales might presently be tilted too far in favor of postpetition lenders. Indeed, empirical data reveals an extremely low default risk for postpetition financing. And, even with the additional perquisites offered under modern bankruptcy law, postpetition lenders still enjoy pricing terms that would ordinarily apply to far riskier investments. Postpetition lenders typically receive a premium rate of interest along with generous fee payments.

Postpetition lenders also traditionally benefit from certain unique aspects of the bankruptcy lending environment, which serve to limit competition. For example, companies in bankruptcy may have limited access to capital markets and, due to the traditional covenants in their prepetition loan documentation, may face considerable transaction costs when they attempt to obtain financing from other lenders. Similarly, agreements among the debtor's prepetition lenders may restrict the debtor's access to postpetition financing. These constraints further empower postpetition lenders to demand high fees and interest rates at the ultimate expense of the debtor's junior stakeholders.

Over the years, courts and commentators have acknowledged that postpetition financing arrangements tend to be overly

by a bankruptcy court: “Creditors are often loathe to knowingly extend credit to entities in reorganization.” In re Glover, Inc., 43 B.R. 322, 324 (Bankr. D.N.M. 1984).

242 Huebner, supra note 241, at 30 ("As it turns out, lending to a debtor in possession can be a smart move."); see also Peter Antoszyk, New Developments in Dip Lending and Cash Collateral: Trends in Debtor in Possession Financing, AM. BANKR. INST., ABI WINTER LEADERSHIP CONFERENCE, Nov. 29-Dec. 1, 2001 ("[L]enders have come to realize that 'DIP financing' can be quite lucrative.").

243 See, e.g., Moody's Comments on Debtor-in-Possession Lending, MOODY'S GLOBAL CORPORATE FINANCE, Oct. 2008, at 4 (noting that of the 297 cases analyzed, "only 2 DIP facilities experienced defaults").

244 In one especially egregious example, the court found that the interest and fees in a postpetition financing arrangement amounted to an interest rate in excess of one hundred percent. In re The Colad Grp., Inc., 324 B.R. 208, 220 (Bankr. W.D.N.Y. 2005).


generous toward lenders, giving them far too much control over
the case. But these inequities and inefficiencies are believed to
be caused by either preexisting differences in relative bargaining
power, a legal framework that has gone too far in its efforts to
attract and protect lenders, or both. For instance, in their
attempts to isolate the causes of the imbalance, some analysts
have focused on the varying degrees of bargaining power possessed
by traditional bank lenders, on the one hand, and hedge funds and
other distressed debt investors, on the other. Other
commentators have contrasted financing arrangements extended
by new postpetition lenders with those offered by the debtor's
prepetition creditors. The Ninth Circuit summarized the
prevailing view thusly: "Debtors in possession generally enjoy
little negotiating power with a proposed lender, particularly when
the lender has a prepetition lien on cash collateral. As a result,
lenders often exact favorable terms that harm the estate and
creditors." But for these dynamics, bankruptcy law assumes
that the debtor will act on its strong economic impulses to drive a
much harder bargain.

247 The observation is eloquently made in Robin Phelan & Ocean Tama, The Use of DIP Financing as a Mechanism to Control the US Corporate Restructuring Process, N. AM. REGIONAL F. NEWS (Int'l Bar Ass'n Legal Practice Div., London, U.K.), Oct. 2010, at 24 ("Lenders routinely use debtor-in-possession financing ... agreements to gain substantial control over debtors in Chapter 11 and the bankruptcy reorganisation process.").

248 See Wei Jiang, Kai Li & Wei Wang, Hedge Funds and Chapter 11, 67 J. FIN. 513, 516 (2012) (noting that "unlike traditional creditors (such as banks and insurance companies) that strive to contain damages on their existing investment at the bankruptcy bargaining table, hedge funds seek out distressed claims for profitable investment" and "are better able to hold highly concentrated, illiquid positions that strengthen their influence at the negotiation table").

249 See, e.g., Richard M. Kohn, Alan P. Solow & Douglas P. Taber, Pure Debtor-in-Possession Financing, 51 THE SECURED LENDER, Nov./Dec. 1995, at 6 (arguing that "lenders [who] seek out opportunities to extend debtor-in-possession financing to companies in Chapter 11 with whom they have no prepetition lending relationship" have "much more leverage than a typical lender whose borrower has filed for bankruptcy"); see also Zdunkewicz, supra note 237, at 1-2 (distinguishing between "defensive" DIP financings provided by prepetition lenders and "offensive" DIP financings provided by new lenders who are seeking to gain control of the company).


251 See In re Ion Media Networks, Inc., No. 09-13125JMP, 2009 WL 2902568, at *4 (Bankr. S.D.N.Y. July 6, 2009) (finding that although debtors are "naturally motivated to obtain financing on the best possible terms," in the bankruptcy setting it is particularly true that
In response, the drafters of the Bankruptcy Code instituted several checks on potential lender overreach. But, reflecting the basic assumption that debtors are at odds with their creditors, these statutory checks turn on a permissive business judgment standard that is deemed to be satisfied when the debtor meets its requisite burden of proof.252 The debtor’s burden of proof is generally considered to be satisfied through the debtor’s declarations and disclosures to the court that the financing was negotiated in good faith and at arm’s length, and that it is to be extended for valid business purposes and in good faith.253 For instance, the debtor must convince the court—generally through its own declarations—that the terms and conditions of the postpetition financing arrangement, including any fees paid thereunder, are fair, reasonable, and the best available under the circumstances, that they reflect the debtor’s exercise of prudent business judgment consistent with its fiduciary duties, and that they are supported by reasonably equivalent value and fair consideration.254 With respect to the granting of secured or superpriority claim status, the debtor must demonstrate “by a good faith effort that credit was not available” on an unsecured or administrative expense basis,255 and, in the case of priming liens, that the existing lienholders are adequately protected.256 However, the debtor need not actually “seek credit from every possible lender before concluding that such credit is unavailable.”257 In deciding whether to approve the proposed


257 Bray, 789 F.2d at 1088; see also Ames Dep’t Stores, 115 B.R. at 40 (holding that approaching four prospective postpetition lenders was sufficient to satisfy the requirements of § 364(c)); In re Sky Valley, Inc., 100 B.R. 107, 113 (Bankr. N.D. Ga. 1988) (acknowledging that in an already tight postpetition lending market, “it would be unrealistic and unnecessary to
financing arrangement, the court is permitted to take into consideration non-economic benefits to the debtor, such that a mere market comparison of credit terms is not determinative.\textsuperscript{258}

Although some bankruptcy courts conduct their own examination of proposed financing arrangements,\textsuperscript{259} the courts most likely to hear large commercial bankruptcy cases—Delaware and the Southern District of New York—do not typically engage in these independent examinations. Rather, as with most other key decisions made by companies in bankruptcy, these and many other bankruptcy courts largely defer to the debtor’s own business judgment unless the court believes that circumstances are egregious.\textsuperscript{260} This is because, as one court explained, the debtor’s right to operate its business includes “the concomitant discretion to exercise reasonable business judgment in ordinary business matters,” including the decision to obtain financing.\textsuperscript{261} Courts avoid second-guessing the debtor’s business decisions, including decisions regarding postpetition financing where, considering all facts and circumstances, the evidence shows that the relevant decisions were based on reasonable grounds and reasonably reflect business require [debtors] to conduct . . . an exhaustive search for financing”), \textit{aff’d sub nom.} Anchor Sav. Bank Fank FSB v. Sky Valley, Inc., 99 B.R. 117, 120 n.4 (N.D. Ga. 1989).

\textsuperscript{258} See, e.g., \textit{In re} ION Media Networks, Inc., No. 09-13125JMP, 2009 WL 2902568, at *4 (Bankr. S.D.N.Y. July 6, 2009) (“Relevant features of the financing must be evaluated, including non-economic elements such as the timing and certainty of closing, the impact on creditor constituencies and the likelihood of a successful reorganization.”).

\textsuperscript{259} See, e.g., \textit{In re} Tenney Vill. Co., 104 B.R. 562, 567–68 (Bankr. D.N.H. 1989) (finding the creditors’ rights relative to the debtor “striking” and “shocking” upon independent examination of the financing arrangements); \textit{In re} Chevy Devco, 78 B.R. 585, 588–90 (Bankr. C.D. Cal. 1987) (demonstrating an exercise of the court’s broad equitable powers to evaluate the impact of the proposed postpetition financing on all stakeholders).

\textsuperscript{260} See \textit{In re} Barbara K. Enters., Inc., No. 08-11474, 2008 WL 2439649, at *14 (Bankr. S.D.N.Y. June 16, 2008) (“The Court is aware that its normal function in reviewing requests for post-petition financing is to defer to a debtor’s own business judgment so long as a request for financing does not ‘leverage the bankruptcy process’ and unfairly cede control of the reorganization to one party in interest” (citing \textit{In re} Ames Dep’t Stores, Inc., 115 B.R. 34, 40 (Bankr. S.D.N.Y. 1990)); \textit{In re} Farmland Indus., Inc., 294 B.R. 855, 881 (Bankr. W.D. Mo. 2003) (“[T]he applicable factors can be synthesized as follows . . . [t]hat the proposed financing is an exercise of sound and reasonable business judgment . . . .”).

\textsuperscript{261} \textit{In re} Simasko Prod. Co., 47 B.R. 444, 449 (Bankr. D. Colo. 1985) (“In exercising [the debtor’s] business judgment of conducting its drilling operations, it has found it necessary to obtain loans to make these endeavors possible. This is in accordance with the exercise of sound business discretion.”).
judgments made in good faith. For instance, courts have found that this standard is met where the record demonstrates that the parties negotiated and reflected their compromises in revised drafts of the lender's proposed financing agreement.

In essence, the law governing postpetition financing presumes that debtors and their postpetition lenders have sufficiently adverse interests. So long as the debtor can show that they bargained at arm's length and engaged in a healthy dose of give-and-take, the agreements they reach will be treated as objective evidence of what is fair, reasonable, and the best available to the debtor under the circumstances. As the following subsection explores, the assumption that debtors and postpetition lenders are always adverse to each other has made it difficult for more comprehensive and protective judicial doctrines, such as the sub rosa plan doctrine, to be applied to postpetition financing arrangements.

C. THE SUB ROSA PLAN DOCTRINE

As Judge Sontchi explained in Horsehead, debtors are not required to auction themselves to the highest bidder. Nonetheless, Chapter 11 debtors increasingly choose to pursue major corporate sale transactions under § 363 of the Bankruptcy Code—a provision that authorizes the debtor in possession or a trustee to sell all or part of the property of the estate. As § 363 asset sales have become more commonplace, some courts and commentators have cautioned that although debtors have broad discretion to conduct sales, they should not be permitted to abuse the sale process and essentially engage in a Chapter 11

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262 See, e.g., In re Federated Dep't Stores, Inc., No. 1-90-00130, 1990 Bankr. LEXIS 472, at *8–11 (Bankr. S.D. Ohio Mar. 15, 1990) (finding that the debtor had exercised “reasonable business judgment” by evaluating the need for the postpetition financing contemplated by the draft agreements, considering other alternatives, and ultimately concluding “that the [c]redit [a]greement represent[ed] the most prudent use of the assets and properties of the estates of the Debtors and the pursuit of reorganization pursuant to the Bankruptcy Code”).

263 See, e.g., In re W. Pac. Airlines, Inc., 223 B.R. 567, 572–73 (Bankr. D. Colo. 1997) (concluding that the debtor in possession had exercised reasonable business judgment because the terms of the financing were negotiated at arm's length and the negotiations had yielded important revisions to the original proposal).

264 Transcript of Ruling on Confirmation Hearing, supra note 35, at 9.


reorganization without going through the more arduous process of drafting and negotiating a plan, soliciting votes, and obtaining court approval by satisfying the requisite statutory safeguards.

The Fifth Circuit introduced the concept of a *sub rosa* ("below the line") plan of reorganization in the 1983 case, *In re Braniff Airways, Inc.* 267 Assessing a § 363 sale, the court explained, "[t]he debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets." 268 According to the Fifth Circuit, a transaction amounts to a *sub rosa* plan if it: (1) specifies the terms of any future reorganization plan; (2) restructures creditors' rights; and (3) requires that all parties release claims against the debtor, its officers and directors, and its secured creditors. 269

Soon after, a 1987 case, *In re Chevy Devco*, 270 evidenced at least one court’s willingness to apply the *sub rosa* plan doctrine to postpetition financing arrangements. In a published opinion that primarily stands for the notion that adequate protection requires something more than a speculative promise of future value, the U.S. Bankruptcy Court for the Central District of California acknowledged that a postpetition financing arrangement can be the equivalent of a plan. 271

Indeed, the debtor itself stipulated that the proposed financing was "equivalent to its plan of reorganization," admitting that it deliberately chose to circumvent plan confirmation requirements and use the more flexible tools afforded under § 364 of the Bankruptcy Code. 272 This is because the latter permitted the debtor to subordinate the prepetition senior secured lender’s lien, while the former prohibited such a result. 273 In an effort to prevent the debtor


268 *Id.* at 940.


271 *Id.* at 589–90.

272 *Id.* at 589.

273 *Id.*
from sidestepping important statutory protections, the court used its equitable powers to treat the proposed financing arrangement like a cramdown, holding it to Chapter 11 plan confirmation requirements. The court articulated the test as follows: "Is a senior lienor being given less than full protection so that a junior creditor or interest can benefit from it? If so, this subordination should not be allowed." Because the court found that the proposed postpetition financing arrangement declined to provide the prepetition senior secured lender adequate protection, the arrangement failed the cramdown standard.

Of course, Chevy Devco is primarily a case about adequate protection, and thus it is not an especially strong doctrinal precedent for applying the sub rosa plan doctrine to postpetition financing arrangements more broadly and for the benefit of other stakeholders. The test of time has proven this. Today, while the sub rosa plan doctrine is regularly applied to § 363 sales—both within and beyond the Fifth Circuit—it has not gained similar traction with respect to postpetition financing arrangements. This is due in large part to the assumption that an inherent dualism between lenders and debtors who are negotiating a new debt instrument makes such coordinated feats unlikely.

One notable recent exception is the 2009 case, In re Belk Properties, LLC, decided by the United States Bankruptcy Court for the Northern District of Mississippi. In Belk Properties, the debtor—a real estate developer struggling to complete a highly leveraged, multi-phase project during an economic recession—sought to obtain an order from the court authorizing it to enter into a postpetition financing arrangement with a distressed investor, Meadowbrook Capital, LLC (Meadowbrook). The proposed financing arrangement not only granted Meadowbrook a priming, superpriority lien in the debtor’s assets, but it also gave

274 Id. at 589–90.
275 Id. at 589.
276 Id. at 589–90.
277 See Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC), 478 F.3d 452, 466–67 (2d Cir. 2007) (applying the sub rosa plan doctrine and holding a settlement was not an impermissible sub rosa plan); In re Capmark Fin. Grp., Inc., 438 B.R. 471, 513–14 (Bankr. D. Del. 2010) (same).
278 421 B.R. 221 (Bankr. N.D. Miss. 2009).
279 Id. at 222.
Meadowbrook immediate control over the project.\textsuperscript{280} Moreover, upon funding the loan, Meadowbrook would receive a controlling 51\% equity position in the debtor, with additional equity conversion rights that, if exercised, would allow Meadowbrook to own up to 90\% of the equity.\textsuperscript{281} Finally, the proposed agreement prohibited the debtor from using loan proceeds for any purpose other than payment of approved budgetary expenditures.\textsuperscript{282}

In its decision denying the debtor's motion, the court identified several problems with the proposed financing arrangement. For one thing, the court criticized the debtor for failing to provide adequate protection to its prepetition secured lenders.\textsuperscript{283} Moreover, the court complained that "Meadowbrook, as the lender, would become the majority owner and the responsible party for the debtor."\textsuperscript{284} The court noted the obvious conflicts of interest and explained that the arrangement would essentially cloak Meadowbrook "with the rights of a debtor-in-possession . . . without having been duly appointed through the procedures of \textsection 1104(a)."\textsuperscript{285} Although these two technical concerns appear to have heavily influenced the court's final decision, the balance of the court's published opinion focused on a more theoretical issue: that the proposed postpetition financing arrangement constituted a \textit{sub rosa} plan.\textsuperscript{286}

Citing \textit{Braniff}, the \textit{Belk Properties} court was quick to acknowledge that the case before it did not involve a \textsection 363 sale.\textsuperscript{287} Nonetheless, it identified a number of factors that caused it to conclude that "[i]n effect, the financing proposal is a clever way for the lender to gain control of the debtor's assets without going through the processes of a \textsection 363(b) sale."\textsuperscript{288} First, the lender "would effectively become the debtor," serving not only as the largest secured creditor, but also as the manager and majority equity

\begin{itemize}
\item \textsuperscript{280} \textit{Id.}
\item \textsuperscript{281} \textit{Id.} at 223.
\item \textsuperscript{282} \textit{Id.} at 224.
\item \textsuperscript{283} \textit{Id.} at 225.
\item \textsuperscript{284} \textit{Id.} at 226.
\item \textsuperscript{285} \textit{Id.}
\item \textsuperscript{286} \textit{Id.} at 225–26.
\item \textsuperscript{287} \textit{Id.} at 225.
\item \textsuperscript{288} \textit{Id.}
\end{itemize}
Moreover, the court noted that the proposed financing arrangement would bind the debtor to pursue a plan of reorganization "consistent with the Term Sheet," and that it "loosely dictat[e]d the manner in which existing creditors . . . [would] be treated." Thus, the court explained that if the financing order was approved, "the plan of reorganization [would be] a fait accompli, that is, . . . an accomplished fact for all practical purposes." For these reasons, the court concluded that "the Meadowbrook postpetition financing proposal . . . violates the holding of Braniff because it achieves the same effect as a sub rosa Chapter 11 plan of reorganization."

Although Belk Properties captured the immediate attention of practitioners as a sign that courts might begin to apply heightened scrutiny to postpetition financing arrangements, the decision has had little impact on broader bankruptcy law and practice. Indeed, at the time of this writing, it has not been cited or discussed in a published court decision although it makes regular appearances in briefs written by parties objecting to proposed postpetition financing arrangements. Courts are apparently persuaded by arguments that the holding applies only to postpetition financing arrangements that give the lender a controlling equity interest prior to plan confirmation. As a
debtor recently explained in defense of a more typical loan structure, "[t]he Equity Conversion feature . . . if exercised, will be part of a plan that will be subject to all applicable confirmation requirements and to which all parties will have a right to object or otherwise contest valuation." Moreover, the same debtor clarified that typical equity conversion features merely "set[] a floor and a path to confirmation," which the debtor has "full fiduciary flexibility to take or not." Provided the value of the company increases prior to plan confirmation, the debtor can arguably avoid the equity conversion altogether by refinancing or repaying the postpetition loan.

In addition to Chevy Deuco and Belk Properties, other published opinions demonstrate how courts have grappled with the occasional need for higher judicial scrutiny of postpetition financing agreements. For instance, the U.S. Bankruptcy Panel of the Ninth Circuit explained in In re Defender Drug Stores, Inc., that there are other circumstances where courts ought not to rely on the permissive business judgment standard:

While certain favorable terms may be permitted as a reasonable exercise of the debtor's business judgment, bankruptcy courts do not allow terms in financing arrangements that convert the bankruptcy process from one designed to benefit all creditors to one designed for the unwarranted benefit of the postpetition lender. Thus, courts look to whether the proposed terms would prejudice the powers and rights that the Code confers in a DIP lender before confirmation including the installation of the lender as the Debtors' manager.

296 Debtors' Omnibus Reply, supra note 295, at 21.
297 Id. at 4.
298 Id. at 21.
for the benefit of all creditors and leverage the Chapter 11 process by granting the lender excessive control over the debtor or its assets as to unduly prejudice the rights of other parties in interest.\textsuperscript{299}

The court concluded that the subject postpetition financing arrangement was not a \textit{sub rosa} plan, and that nothing about the proposed terms would enable the lender "to control the actions of the debtor nor prevent other parties from exercising their rights."\textsuperscript{300} The U.S. Bankruptcy Court for the District of New Hampshire conducted a similar analysis, finding that a postpetition financing arrangement essentially transferred the economic value of the estate and control over the debtor's business to the lender, in violation of the debtor's fiduciary obligations.\textsuperscript{301} The court explained that the proposed financing agreement would effectively "disarm the [d]ebtor of all weapons usable against [the lender] for the bankruptcy estate's benefit, place the [d]ebtor in bondage working for [the lender], seize control of the reins of reorganization, and steal a march on other creditors in numerous ways."\textsuperscript{302}

As objecting parties from a myriad of recent Chapter 11 cases have discovered, this narrow body of jurisprudence does not do much to bolster arguments against more typical forms of postpetition financing. This is because, taken together, these cases stand only for the proposition that heightened judicial scrutiny is necessary when the postpetition lender effectively becomes the debtor, either because it accepts a majority equity stake or managerial position during the pendency of the case (as in \textit{Belk Properties}), or because it assumes "excessive control over the debtor or its assets" (as the \textit{Defender Drug Stores} court cautioned).\textsuperscript{303} In either event, the collapsing of the debtor and postpetition lender into essentially one party removes the natural tendency for adversarial relations, as well as any semblance of arm's length negotiations. As the highly influential U.S. Bankruptcy Court for the Southern District of New York explained, excessive control

\textsuperscript{300} \textit{Id.} at 318.
\textsuperscript{302} \textit{Id.} at 568.
\textsuperscript{303} 145 B.R. at 317.
threatens the smooth functioning of the bankruptcy laws by "skew[ing] the carefully designed balance of debtor and creditor protections that Congress drew in crafting Chapter 11."\textsuperscript{304} Because most forms of postpetition financing agreements do not contemplate an immediate transfer of equity, parties are left to litigate whether certain provisions amount to excessive control. Given that most forms provide fiduciary and other "outs" for the parties, these arguments have been difficult to sustain.

In essence, the limited body of jurisprudence applying the sub rosa plan doctrine to postpetition financing arrangements does not actually challenge the underlying assumption that debtors are naturally adverse to their creditors; rather, these precedents merely provide a narrow doctrinal alternative for those exceptional cases where a creditor and debtor clearly become alter egos of each other. The following section considers the unique role postpetition financing arrangements play in bearish bankruptcies, particularly when they are accompanied by equity conversion features or exclusive rights offerings.

D. THE ROLE OF POSTPETITION FINANCING IN BEARISH BANKRUPTCIES: HORSEHEAD REVISITED

For the reasons described above, postpetition financing arrangements in all Chapter 11 cases are capable of shifting or reinforcing the balance of power among the parties and foreclosing other restructuring outcomes that may better advance the interests of stakeholders. But in bearish bankruptcies, the risks are even greater. This is because the lack of meaningful substantive and procedural protections for shareholders effectively strips the rights to the debtor's unlimited upside away from equity owners, leaving them to be reallocated in the bankruptcy proceedings. But debtors and their dominant creditors do not wait for the regular plan confirmation process; rather, they use postpetition financing arrangements and related instruments to lock in claims to the debtor's full upside potential.

Consider, for instance, the postpetition financing agreement and related instruments entered into in Horsehead. On the same day that it filed for bankruptcy protection, Horsehead Holding also

filed a motion seeking the court's permission to enter into a $90 million senior secured superpriority debtor-in-possession financing agreement. The proposed postpetition lenders were a group of prepetition creditors holding more than 80% of the company's outstanding senior secured notes. The court approved the postpetition financing on an interim, and later final, basis, allowing the debtor immediate access to the requested financing and also obligating it to comply with the agreement's aggressive milestones and other onerous provisions. For instance, the initial agreement provided that within forty days of the petition date, the debtor must file a draft plan of reorganization that is acceptable to the postpetition lenders and its other senior secured lenders. Although this and other milestones were extended several times during the case, the unsecured creditors committee complained that the tight timelines made it extremely difficult for other parties to conduct the necessary diligence and properly vet the debtor's disclosures and proposals.

Working quickly to comply with the milestones, the debtor proposed a draft plan that would extinguish existing equity and eliminate substantially all of the company's debt by converting approximately $205 million of its senior secured debt into equity in the reorganized company, repaying certain other obligations in full, and distributing cash, equity, and warrants to other creditors. The debtor also proposed a Unit Purchase and

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306 Id. at 2.

307 See generally Interim Order, supra note 50.


309 Interim Order, supra note 50, at 46.


Support Agreement (the UPA). This agreement reflected mutual promises between the debtor and its senior creditors to provide the reorganized company access to exit financing up to $260 million,\(^{312}\) of which approximately $100 million would be used to revive the idled plant.\(^{313}\) However, this capital commitment would not take the form of debt; rather, it would be a new equity issuance by the reorganized debtor to certain of the postpetition and other senior secured lenders.\(^{314}\) Containing many of the same provisions that normally appear in postpetition loan documents—such as case milestones and termination rights—the UPA also provided that, subject to a limited obligation to entertain proposals brought by other interested parties to the bankruptcy case, the debtor would “cease any ongoing solicitations and negotiations with any person with respect to any Alternative Transaction,” and would “not directly solicit any inquiries or the making of any proposal or offer relating to an Alternative Transaction, participate in any discussions or negotiations, or provide any non-public information to any person with respect to an Alternative Transaction.”\(^{315}\) In the event that the debtor exercised its limited fiduciary out and agreed to enter into an alternative transaction, then the debtor would be obligated to pay a $7.5 million termination fee to its counterparties under the UPA.\(^{316}\) The Official Committee of Equity Security Holders objected to the proposed agreement on the grounds that, among other things, the termination fee was in

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\(^{312}\) See Debtors' Motion for Entry of an Order (I) Approving the Unit Purchase and Support Agreement and Authorizing the Debtors to Honor Their Obligations Thereunder, and (II) Granting Related Relief at 2, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Aug. 9, 2016) [hereinafter Debtors' Motion for Entry of an Order] (discussing how the $160 million Emergency Equity Purchase and the $100 million Additional Capital Commitment in the UPA will work together to help the debtor refinance and reorganize). The UPA was the product of earlier negotiations, as a draft of the agreement was previously disclosed in the Debtors' Second Amended Disclosure Statement, supra note 20, at Ex. F.

\(^{313}\) Reply in Support of Debtors' Motion for Entry of an Order (I) Approving the Unit Purchase and Support Agreement and Authorizing the Debtors to Honor Their Obligations Thereunder, and (II) Granting Related Relief at 2, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Aug. 26, 2016).

\(^{314}\) Debtors' Second Amended Joint Plan of Reorganization, supra note 24, at 20 (discussing how senior secured noteholders will receive "New Common Equity" as a part of the Additional Capital Commitment plan).

\(^{315}\) Debtors' Motion for Entry of an Order, supra note 312, at 6.

\(^{316}\) Id. at 11.
"conflict with the debtor's duty to maximize the value of the bankruptcy estate."  

But the court approved the debtor's entry into the UPA based on the same permissive business judgment standard that governs other forms of postpetition financing. Of course, as an equity issuance rather than a debt issuance, the transaction was a § 363 "use...other than in the ordinary course of business, [of the] property of the estate." But the court did not consider the possibility that the agreement—alone or in conjunction with other agreements—might be a sub rosa plan. Rather, the debtor enjoyed the benefit of the business judgment rule and was only required to "show a sound business purpose" justified the proposed use of the property, meaning it was reasonable rather than arbitrary or capricious. The debtor emphasized the importance of raising capital to the plan's ultimate success and reiterated that it was naturally adverse to the creditors who were agreeing to invest in the reorganized company: "[t]he Debtors and their advisors engaged in substantial, arm's length negotiations in good faith with the Plan Sponsors, all of whom are sophisticated parties who have retained counsel and financial advisors, to arrive at the terms of the UPA."  

As explained above, the capital commitments contemplated under the UPA ultimately became the linchpin for the company's existing shareholders. Although the court momentarily acknowledged that the company may be solvent, it found that shareholders had failed to overcome this additional valuation hurdle. Accordingly, Horsehead demonstrates how bearish debtors and their postpetition lenders may use postpetition

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317 Objection of Official Committee of Equity Security Holders to Debtors' Motion to Approve the Unit Purchase and Support Agreement at 4-5, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Aug. 23, 2016).
318 Order (I) Approving the Unit Purchase and Support Agreement and Authorizing the Debtors to Honor Their Obligations Thereunder, and (II) Granting Related Relief at 2, In re Horsehead Holding Corp., No. 16-10287 (Bankr. D. Del. Sept. 9, 2016).
322 Debtors' Motion for Entry of an Order, supra note 312, at 10.
323 See supra note 46 and accompanying text.
financing arrangements and related instruments to place the debtor on a path that requires it to pursue a series of mutually interdependent debt and equity issuances. In this way, these agreements should be understood to form a single, integrated restructuring transaction. For their part, postpetition lenders have the power, under state law and the Bankruptcy Code, to effectively lock up the estate during the pendency of the case, albeit without the fiduciary responsibilities that a debtor has to maximize value for the benefit of other stakeholders. Meanwhile, the debtor promises to focus its efforts on developing and gaining confirmation of a plan that is acceptable to these creditors. To this end, the debtor agrees to curtail plan negotiations and resist meaningful consideration of alternative proposals. Although most modern agreements give the parties fiduciary outs, these instruments in substance strongly incentivize continued pursuit of the plan. Far from serving as checks on each other, debtors and their postpetition lenders at times basically team up to make the powers afforded to them under the Bankruptcy Code absolute.

For instance, under prevailing practice, bearish debtors and their dominant stakeholders can use postpetition financing arrangements to increase the so-called secured debt hurdle, or the amount of secured debt that the debtor's enterprise value must exceed before unsecured creditors and equity security holders will be entitled to a distribution. By increasing the secured debt hurdle through postpetition extensions of credit, debtors and their senior secured lenders are able to mitigate economic and legal uncertainty during the pendency of the case and streamline confirmation of the plan. And, as Horsehead reveals, postpetition lenders do not even have to extend all of the funds during the pendency of the case; rather, mere commitments for new postconfirmation equity funding can also be used to increase the valuation hurdle.

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324 See, e.g., 11 U.S.C. § 364 (authorizing lenders to secure senior or equal liens on the property of a debtor's estate).
325 See, e.g., Debtors' Post-Trial Brief in Support of Debtors' Amended Joint Prearranged Chapter 11 Plan Dated September 4, 2015 (SSBT Issues), at 2–4, In re Boomerang Tube, LLC, No. 15-11247 (exemplifying how postpetition financing agreements can increase the debt hurdle).
All of this suggests, then, that postpetition financing agreements should not be looked upon by courts merely as debt instruments\textsuperscript{326} entered into by naturally opposing parties. Courts and lawmakers should recognize the potential for these instruments—particularly when executed in tandem with equity participation and support agreements—to serve as agreements between debtors and certain stakeholders to pursue sub rosa plans. Collectively, these agreements give certain creditors excessive control over the debtor and its assets. And, while it is true that the plan is still subject to the regular confirmation process, these statutory safeguards are often illusionary. For one thing, shareholders may be denied a seat at the table; and, in any case, junior stakeholders only really have the right to contest valuation.\textsuperscript{327} But valuation is already difficult to ascertain in bearish bankruptcies, particularly given the limitations of prevailing corporate valuation techniques.\textsuperscript{328} Finally, even if junior stakeholders are able to overcome the weight of the debtor’s evidence, their efforts will be futile if the debtor can simply use postpetition debt and equity commitment agreements to push the valuation hurdle higher and higher. These dangers exist in all commercial bankruptcies, but they are particularly significant in bearish bankruptcies, where there are strong economic incentives to quickly lay claim to valuable, unprotected upside rights. When postpetition financing arrangements are used in this way, they have the potential to impermissibly alter the Chapter 11 process from one designed to maximize value for all stakeholders to one explicitly fashioned for the sole benefit of certain stakeholders.

\textsuperscript{326} The point of this Article is not to challenge the bona fide nature of the prototypical postpetition financing instrument for all purposes. Rather, the analysis is intended to challenge the assumptions reflected in the law governing these arrangements, and to provide a unique vantage point from which to assess the true risks they pose to fundamental fairness, equality of treatment, and the overall efficacy of the commercial restructuring process—particularly in bearish bankruptcies.

\textsuperscript{327} See, e.g., In re Granite Broad. Corp., 369 B.R. 120, 140 (Bankr. S.D.N.Y. 2007) (demonstrating an objection to valuation and holding that “[t]here is no dispute that a class of creditors cannot receive more than full consideration for its claims, and that excess value must be allocated to the junior class of debtor or equality”).

\textsuperscript{328} See supra Part II.
V. DISCUSSION

This Article shows how bearish bankruptcies exploit existing weaknesses in Chapter 11 to transfer valuable upside rights from shareholders to certain stakeholders without compensation. The findings have the potential to redirect bankruptcy reform efforts in dramatic ways. Courts and lawmakers should address the problem through careful reconsideration of bankruptcy law and practice. Reforms are necessary to improve the fairness and efficacy of the commercial bankruptcy process, and to restore the investing public's faith in Chapter 11 as a legitimate means of reorganizing distressed firms.

First and foremost, courts and U.S. Trustees should take steps to identify at the commencement of a Chapter 11 case whether the majority of the debtor's earnings is exposed to one or more commodity markets. For ease of determination, the voluntary petition form could include boxes that debtors would check to indicate whether they meet this criteria. Simply by acknowledging that it is dealing with a bearish bankruptcy, a court is more likely to understand the unique incentive effects that may drive debtors and other stakeholders to pursue certain restructuring outcomes.

Courts presiding over bearish bankruptcies should also take special steps to protect residual claimants, including shareholders. U.S. Trustees should be required to conduct a meeting of equity security holders at the same time that they conduct a creditors meeting, and they should be required to form official committees for unsecured creditors, on the one hand, and equity security holders, on the other, in the earliest days of the case. The unsecured creditors committee cannot be expected to represent equity holders. Particularly in bearish bankruptcies that

329 Such goals are consistent with both Congress's and the Supreme Court's stated intentions for the Bankruptcy Code specifically and bankruptcy law more broadly. As the Supreme Court has repeatedly explained, a principal purpose of the Bankruptcy Code is to provide debtors and creditors with the "prompt and effectual administration and settlement of the [debtor's] estate." Katchen v. Landy, 382 U.S. 323, 328 (1966) (quoting Ex parte Christy, 44 U.S. 292, 312 (1845)); see also Celotex Corp. v. Edwards, 514 U.S. 300, 308 (1995) (noting that Congress granted bankruptcy courts with comprehensive jurisdiction so "they might deal efficiently and expeditiously" with bankruptcy matters (quoting Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984)))). Similarly, "[e]ase and centrality of administration are thus foundational characteristics of bankruptcy law." French v. Liebmann (In re French), 440 F.3d 145, 155 (4th Cir. 2006) (Wilkinson, J., concurring).
contemplate debt-to-equity swaps, these junior stakeholders struggle enough to advance their own interests and may ultimately be incentivized to support the debtor's low valuation estimates in exchange for some portion of the equity in the reorganized company. A bearish debtor's claims of hopeless insolvency should have no bearing in the decision to appoint an official equity committee, as economic theory—and the debtor's own decision to reorganize rather than liquidate—suggest that equity's option right may have substantial value. In other words, because shareholders normally have a right to the debtor's unlimited upside potential after all creditor claims are satisfied, and because prevailing corporate valuation techniques may not fully reflect the debtor's upside potential, shareholders should be deemed to have an economic stake in the proceedings notwithstanding the debtor's balance sheet or its claims of hopeless insolvency.

As a general matter, bankruptcy courts, U.S. Trustees, and the SEC should be mindful of the unique concerns of shareholders of bearish debtors, and should carefully monitor the debtor's disclosures and decisions in these cases. In particular, courts should not rely on hypothetical liquidation analyses to determine whether cramdowns are fair and equitable; by definition, hypothetical liquidation analyses ignore the upside potential and thus decline to take into account equity's potentially valuable option right. Where a bearish debtor and its senior creditors deliberately pursue reorganization rather than liquidation in the hopes of weathering a downturn in commodity prices, it seems anything but fair and equitable to use hypothetical liquidation values as a benchmark for determining whether existing equity owners are being treated appropriately. Indeed, there is a strong case to be made that there should never be an equity cramdown in bearish bankruptcies: debtors should be required to leave existing equity interests intact and use other instruments—such as preferred stock or new debt contracts—to restructure their obligations. Alternatively, bearish debtors should be required to attempt a public rights issue, with the bankruptcy court overseeing a competitive bid process for underwriting, or they

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330 The basic mechanics of a rights issue are described in Mark Mobius, Equities: An Introduction to the Core Concepts 77–78 (2007).
must agree to issue options or warrants entitling existing shareholders to receive equity interests in the reorganized company if the value reaches or exceeds a predetermined threshold by some future date.\(^{331}\) Devices of this sort reflect a deeper understanding of how cyclical and self-correcting commodities markets influence the true value of a bearish debtor.

Bankruptcy courts should be especially mindful of the limitations of traditional corporate valuation techniques when applied to commodity-based debtors. Modern accounting practices reflect a conservative bias that can be easily exploited by debtors seeking to transfer excess value to dominant or preferred stakeholders.\(^{332}\) And, in today’s commercial bankruptcies where creditors exert enormous control over the debtor,\(^{333}\) the persistent focus on earnings as a determinant of enterprise value may no longer make sense. This is especially true in bearish bankruptcies, where prevailing methods of assessing value on the basis of future cash flows fail to fully capture the upside potential of commodity-based companies. As an alternative, courts could require that bearish debtors use so-called options pricing techniques to estimate the value of equity’s stake.\(^{334}\) Options pricing models acknowledge the inherent "option characteristics of equity"; in other words, these approaches recognize that in all cases, equity will have value, even if the value of the firm falls well

\(^{331}\) The option model was famously explored in Lucian Arye Bebchuk, A New Approach to Corporate Reorganizations, 101 Harv. L. Rev. 775, 785 (1988) (proposing a corporate reorganization process pursuant to which stakeholders receive options rather than pure shares in the reorganized company). More recently, a hypothetical option device was recommended by the American Bankruptcy Institute’s Commission to Study the Reform of Chapter 11 in published results of its in-depth, three-year study of commercial restructurings under Chapter 11. Under the proposal, the debtor’s fulcrum security would, in certain cases, receive the so-called redemption option value, meaning the hypothetical value of an option to purchase the reorganized company and satisfy the senior debt in full. COMMISSION TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INS., 2012–2014 FINAL REPORT AND RECOMMENDATIONS 209 (2014).

\(^{332}\) See Dick, supra note 120, at 1496 (explaining the extraordinary power of debtors to transfer value to preferred stakeholders).

\(^{333}\) The point is eloquently made in Baird & Rasmussen, supra note 92, at 675.

\(^{334}\) This approach has been the subject of considerable recent attention in finance literature studying commodity markets. See generally, e.g., Kuangyuan Zhang et al., The Real Option Value of Mining Operations Using Mean-Reverting Commodity Prices, 28 Min. Econ. 11 (2015). It was also used to reconsider Chapter 11 reorganization values in Jeremy Murphy, Bankruptcy Avant-Garde, 19 Am. Bankr. Inst. L. Rev. 113 (2011).
below the face value of the outstanding debt. While equity's underlying option may have little value in many Chapter 11 cases, it should be expected to have substantial value in bearish bankruptcies. Indeed, some corporate finance scholars comparing options pricing theory to DCF analyses estimate that the latter approaches ignore up to one-third of a commodity-based firm's value.

Finally, and perhaps most importantly, courts should apply greater scrutiny to the postpetition financing arrangements and any related instruments proposed by bearish debtors. Instead of relying on a permissive business judgment standard, Congress and the courts should impose stricter controls on the debtor's postpetition financial decision-making to limit its discretion and reduce reliance on its own declarations, disclosures, and business judgments. Courts should scrutinize postpetition financing transactions and their accompanying equity participation and support agreements—just as they monitor sales or settlements—to ensure that they are not actually clever attempts by debtors to avoid statutory safeguards by engaging in sub rosa plans. To this end, bankruptcy judges should make regular use of their equitable powers and impose a balancing test that takes into account the benefits and detriments of these proposed transactions to the debtor's other stakeholders.

Of course, there is a strong argument that the transactions described in this Article are the only—and the most efficient—mechanisms for rational, value-maximizing distressed companies to seek much-needed capital and remain in business. It may very well be that they are driven to pursue bearish bankruptcy reorganizations during periods in their economic cycle when their capital structure has become overly restrictive and the equity markets are more receptive to them than the debt markets. Indeed, the actions of Horsehead Holding's dominant, self-interested stakeholders—who agreed to trade their senior debt


336 See, e.g., Jason Hall & Shannon Nicholls, Valuation of Mining Projects Using Option Pricing Techniques, FINSSIA J. APPLIED FIN. 2007, at 22 (examining "the difference between DCF and real options valuation of mining projects").
positions for equity positions and to also infuse additional equity capital commitments—certainly suggest that this was the case. But while bearish debtors should be able to pursue these efficiencies and access needed capital, bankruptcy law requires that they do so in a fair and equitable manner. This means that their subsequent bite at the equity market apple should not be taken at the expense of existing shareholders, who have already demonstrated their willingness to invest in the company and endure this and future bear markets.

VI. CONCLUSION

Modern bankruptcy law and practice generally excludes shareholders from the Chapter 11 negotiation table and, in so doing, leaves an important source of value—the rights to the debtor's unlimited upside potential—wholly unprotected. In the case of commodity-based firms that enter bankruptcy during a bearish market, the upside potential may be substantial. Far from overlooking this source of value, bearish debtors and their dominant stakeholders use complex and largely misunderstood commercial arrangements to secure rights to this asset in the earliest days of the Chapter 11 case. Reforms are needed to restore the fairness and integrity of the commercial bankruptcy process. Courts must take steps to identify bearish bankruptcies and apply a special set of rules that take into account the unique incentive effects that are present in these cases. Until then, bankruptcy courts will continue to unwittingly transfer undeniable sources of value from shareholders to other stakeholders, in contravention of fundamental bankruptcy and corporate law theoretical principles.

337 See also Part IV.D.