Federal Cases

Federal Statutes

Federal Rules

State Rules

Federal Regulations

Other Authorities

THE NEW FACE OF DOUGLAS BAIRD

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Douglas Baird's genial, capacious and suggestive account of "The New Face of Chapter 11" is a suitable recognition of the Code's 25th Anniversary. It is also, I think, a rather different paper than Baird would have written 25 years ago.[1] I am not talking about substance where, of course, change is exactly Baird's point. Rather, I am talking of style. Baird came to the attention of the academic world in an extraordinary series of papers with his mentor, Thomas H. Jackson.[2] By almost universal assent, these papers were original and thoughtful, and they very likely changed the face of bankruptcy law. But there was an eerie sort of abstraction about them. I always felt about Baird and Jackson on bankruptcy a little like I feel about Henry James on love: remarkable stuff, but can you trust an author who doesn't seem to know how babies are made?[3]

The new Baird seems to have pried himself loose from the library, or he has moved out of the stacks to the place where they keep the Wall Street Journal on a long stick in the lobby. As far as I am concerned, this is all to the good. His current paper is full of what you need to give juice to his scholarship: anecdote and counter-example. He is able to move easily through the experience of chapter 11 over the last decade or so, particularly with regard to the big cases. The result is not neat

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[1] I fudge. Strictly speaking, what he published 25 years ago was a work suitable for (I will do this only once) a man of his caliber. *See* Douglas Baird, *Human Cannonballs and the First Amendment:* Zacchini v. Scripps-Howard Broad. Co., 30 STAN. L. REV. 1185, 1185 (1978) (analyzing defendant's claim of First Amendment privilege to broadcast news footage of plaintiff).

[2] *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984); Douglas Baird & Thomas H. Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. LEGAL STUD. 299 (1984); Douglas G. Baird & Thomas H. Jackson, *Kovacs and Toxic Wastes in Bankruptcy*, 36 STAN. L. REV. 1199 (1984); Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175 (1983).

[3] In fairness, there aren't a lot of places where you do get to see chapter 11 in all its fullness. You get part way there by rummaging around in the formidable database assembled by Lynn LoPucki. Among many other candidates, see in particular Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code? (First Installment)*, 57 AM. BANKR. L.J. 99, 103 (1983) (focusing on debtors that file under chapter 11); Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code? (Second Installment)*, 57 AM. BANKR. L.J. 247, 247–48 (1983) (examining lack of creditor participation). Helpful from a different approach is STUART C. GILSON, CREATING VALUE THROUGH CORPORATE RESTRUCTURING (2001), which answers questions about ways in which corporate restructuring affects nature of corporations. One provocative but too much neglected attempt is Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 721 (1991), which offers a competing normative explanation of bankruptcy law, that author calls the value-based account to counter the economic account of bankruptcy law.

and elegant – perhaps not even as neat as Baird suggests – but that is precisely its charm.

I mean to take nothing away from what I just said if I offer some second thoughts. Inevitably, I will find myself impelled to criticize Baird for failing to write the paper he never pretended to right, but I will try to control that impulse.

As I understand it, Baird's main point about large chapter 11s is that the Code has ceased to be (whatever it was before) and has become a device for maintaining going concern values while assets are sold.[4] Nineteenth Century reorganizations (if I read right) could not have performed this function because there simply was not a liquid market – inside bankruptcy or out – for asset transfer on this scale.

I am largely in sympathy with this view. I guess my principal regret is that Baird never seems to step up to the plate and connect with this transformation in terms of our expectations for chapter 11 as a social institution. In crude outline: we can conceive of chapter 11 from two overlapping, but ultimately quite different, perspectives – a point I struggled to articulate in an earlier piece.[5] On the one hand, we can see chapter 11 as a device for protecting *assets*. On the other, we can see it as a device for protecting *equity*.

These purposes can keep company together. For a first example (call it #A), suppose the assets are worth $120 as a going concern and $80 in liquidation. Suppose debt is $100. Then both ends of the boat are sinking, and equity shares with debt a common interest in saving the going concern. But what if the debt were $150 (call it case #B)? Then debt has an interest in preserving the going concern, even though equity has no dog in the fight.

Perhaps even more useful for purposes of illustration is the third paradigm (call it #C), the case where debt is $130 going into the case but, when the dust settles, it turns out that debt is scaled back to $110, while preserving the going concern. The result here is, of course, to leave a stake for equity that was not there before.

I apologize for repeating a drill, which, to any experienced bankruptcy professor, is no more than a finger exercise. My point is that if an old-fashioned bankruptcy lawyer (or professor) had anything in mind when he discussed corporate restructuring, I think the chances are it was case #C, or maybe #C fudged with #A, or maybe all three fudged together. Indeed I have long suspected that maybe the whole purpose was fudge: the purpose of creating a system that deliberately obscured a conflict of purpose.

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[4] Douglas R. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 80–82 (2004).

[5] *See* John D. Ayer, *Bankruptcy as an Essentially Contested Concept: The Case of the One-Asset Case*, 44 S.C. L. REV. 863, 888–89 (1993) (stating drafters may have purposefully left leeway in Code rendering interpretation "muddy"). On the multiple purposes of bankruptcy, see John D. Ayer, *Through Chapter 11 With Gun or Camera, But Probably Not Both: A Field Guide*, 72 WASH. U. L.Q. 883, 904 (1994), explaining variety of purposes to chapter 11, some overlapping and similar. On the use of chapter 11 as a forum for liquidating creditor's claims, see John D. Ayer, *The New Chapter 11*, NORTON BANKR. L. ADVISER, June 1985, at 1–3. On the changing role of bankruptcy, see Elizabeth Warren & Jay Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. No. 7, at 12 (Sept. 2003), which notices that chapter 11 cases are becoming vehicles through which secured parties can enjoy Article 9 rights under protection of bankruptcy law.

In his paper, I *think* Baird is saying that chapter 11 has become a device for the preservation of asset values. Or, more precisely, he focuses on the preservation of asset values, and I think I may be entitled to a negative inference that he believes preservation of asset values includes maintenance of creditor claims. Of course a moment's reflection will suggest that no such inference is logically necessary – we can perfectly well imagine a system that preserves asset values and trims down creditor claims at the same time.

So far as I can tell, Baird does not really fix his formidable analytical talents on the matter of trimming down creditor claims: not here and, for what it is worth, so far as I can tell, not elsewhere in his work. I infer (again perhaps by indirection) that he does not zero in on it because he does not approve of it. Disapproval turns into disbelief: if something should not be true, then it is not true, the white-collar crime that dare not speak its name. As a strategy for living, this approach is consoling but risky. I would rather say that the idea of trimming down debt is a bit like the sacrament of infant baptism: whether you believe in it or not, you have seen it thousands of times.

In the same vein, I think it might have helped to clarify the point if Baird had offered some thoughts on the (seeming?) discontinuity between what chapter 11 does and what the drafters thought it would do.[6] As I suspect almost anyone in the current audience would agree, in the light of Baird's account, the conceptual structure of the current Bankruptcy Code makes no sense. I don't mean that it is nonsensical, only that the drafters had a much different reality in mind.

Specifically, chapter 11 is entitled "Reorganization," but no one can give an exact and concise definition of "reorganization." We may say that the purpose of chapter 11 is to "preserve going concern values," but we know that it is perfectly possible to preserve going concern values in chapter 7 and that it is permissible and often desirable to destroy going concern values in chapter 11. We know that the debtor's business usually continues to operate in chapter 11, but that it doesn't always continue to operate in chapter 11, and there is no specific bar to operating the business in chapter 7.

We know that in the typical chapter 11, no trustee is appointed, and the debtor remains in possession, but this fact itself is ambiguous. Leaving the debtor in possession may give the old equity owners a second bite at the apple. But as Baird's own account demonstrates, very often leaving the debtor in possession can be understood as a value-enhancing economy move.[7]

For my money, the most noteworthy and provocative feature of chapter 11 is that in the ordinary course, the debtor has a period of exclusivity during which she,

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[6] *See, e.g.*, John D. Ayer, *Abolish Chapter 7*, NORTON BANKR. L. ADVISER 1, 6–7 (1996) (concluding protecting debtors and creditors cannot be simultaneous goals and that instead value maximization is goal of bankruptcy proceeding). *See generally* John D. Ayer, *Dialectic in the Corner Pocket*, NORTON BANKR. L. ADVISER, Feb. 1991, at 11.

[7] *See* Baird, *supra* note 4, at 81 (citing large bankruptcies rife with fraud in which debtor stayed in possession, stating lenders controlling reorganization prefer appointing chief restructuring officer over trustee).

and only she, can propose a plan.[8] Indeed, to say "the debtor" here is itself ambiguous, but I think we can read it to mean "the equity owners of the debtor," those who will be wiped out in too hasty a reorganization, but who will survive under the right kind of plan.

What could the drafters have been thinking of? As I understand it, here is a classic chapter 11, seen in the drafter's mind's eye. The debtor is a closely held family corporation: Grandma's Pie Company, Inc. (call it "PieCo"), of which John C. Grandma is president and principal shareholder. PieCo has some secured debt, but it has a substantial chunk of "vendor debt," all unsecured. To varying degrees these vendors can be understood as co-venturers with the pie company – a lot of them have situation-specific capital tied up in the relationship whereby they would lose almost as much as the debtor if the debtor were to collapse.

At any rate, on this model when PieCo gets into trouble, he parlays with the vendors: he gets their agreement that they both need the going concern, and together they hash out the question of who takes how much of a hit. They use the chapter 11 device, if at all, to hold outliers at bay during negotiations, and to impose the general agreement on dissenters.

I do not insist that this picture describes any particular chapter 11, ever (though as a practical matter, I think there probably are plenty of real-world examples). I do not suggest that it ever had much to do with the "big-case" public-company cases of which Baird writes so well. I do suspect (and I think Baird would agree) that it does not describe very many cases today, big or small. And I strongly believe – this is why I brought it up—that chapter 11 was written with this kind of case in view. One thing I wish Baird had done (although I admit that he did not try) is to evaluate how his picture of the current chapter 11 fits into this somewhat Procrustean bed.

Although he doesn't discuss my idea of a "classic" case, Baird does offer some thoughts on his "New" chapter 11, in the prism of the old equity receivership.[9] Here I am on somewhat more shaky ground, partly because I have doubts about my own knowledge, partly because I am not so sure about Baird's. I am writing this note based on an unfootnoted draft, so I cannot be certain exactly what Baird relies on when he discusses the equity history. I do, however, entertain two thoughts: one, we really don't know all that much about what went on in the equity receiverships, and two, whatever it was, it probably was not very neat.

Indeed, it is precisely when he talks about the equity receiverships that he begins to sound like the abstract Baird of old, stimulating or provocative in his analysis, but not necessarily inspiring a great deal of confidence in detail.[10] He does

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[8] 11 U.S.C. § 1121(b) (2002) ("Except as otherwise provided in this section, only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter.").

[9] *See* Baird, *supra* note 4, at 81–82 ("The disappearance of the traditional reorganization stems . . . from changes in the economy that have been underway for a long period of time. The equity receivership of the 19th Century . . . was desirable because of a conjunction of a number of different [economic] conditions.").

[10] *See id.* at 71–75 (comparing and contrasting modern chapter 11 to equity receiverships of 19th century).

offer a sketch of a model of the equity receivership.[11] It is neat, and I doubt its very neatness: few things are that neat, and what evidence we have gives no reason to suspect that the equity receivership is any different from everything else. As I conceded above, I do not have a lot of evidence, but anyone who wants to pursue the point might want to consider Bradley A. Hansen's absorbing and at times hilarious account of how Jay Gould took the creditors of Wabash Railroad and left them rinsed, spun and pretty much hung out to dry.[12]

So much for general thoughts. Now allow me to offer a few disjointed particulars:

- Baird compares fiber optics in the 21st Century with railroads in the 19th.[13] I think there is a lot of merit to this comparison, although I am not sure Baird puts his finger on what seems to me the important point. That is: in both cases we observe a huge investment (overinvestment?) in situation-specific capital, leaving creditors with no exit-strategy. If I buy go broke running a supertanker, the chances are that the creditors can send it to Calcutta or Macao and put it to productive use again. If I build a railroad, all I have is a ribbon of rust across the desert. My friend Mary had to foreclose (in a fiber optics case) on a 30-mile ditch around Fresno. What are you going to use it for, a moat?[14]

  In this vein, it strikes me as odd that Baird would discuss these cases in terms of "fraud."[15] I have not any doubt that there was plenty of fraud in both fiber optics and railroads, but I think the point is that there would have plenty of misfortune even if everyone played the game like gentlemen. The real problem was overcapacity. Indeed, trying to build an account of these misfortunes on the aroma of fraud is like trying to make water out of elemental gasses – fill an armory full of hydrogen and oxygen, you have a big boom, and you barely get your feet wet.

  At the risk of laboring the point I think this is the trouble with Baird's assertion that the railroads were cash flow solvent. True enough (I suspect) but the real problem was not the income statement, it was the balance sheet.
- I said a word above about the DIP/trustee, but let me return to the point. Baird is quite right to highlight the fact that in virtually no large chapter 11 case does the court appoint a trustee.[16] This is quite right as far as it goes, but I really wish he had popped the hood on this one. I am probably just

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[11] *See id.* (describing structure and goals of equity receivership applied to railroads reorganized during 19th century).

[12] *See generally* Bradley A. Hansen, *The People's Welfare and the Origins of Corporate Reorganization: The Wabash Receivership Reconsidered*, 74 BUS. HIST. REV. 377 (2000).

[13] Baird, *supra* note 4, at 70.

[14] This point first sank into me when I studied the history of the New York subway system. Over and over someone would dig half a hole and then abandon to fester until the next risk-taker came along. *See generally* CLIFTON HOOD, 722 MILES: THE BUILDING OF THE SUBWAYS AND HOW THEY TRANSFORMED NEW YORK (1995).

[15] Baird, *supra* note 4, at 70–71.

[16] *Id.* at 84.

indulging my own tastes here, but it seems to me one of the major issues in chapter 11 today is the question of "duty of loyalty" in the management of a shaky business. As Baird of course knows, one reason why the court doesn't feel the need to appoint trustees in major chapter 11s is that the parties have often taken care of the matter themselves, for example, by replacing the old management with a turnaround specialist.

This system has some obvious virtues, but I think it highlights (or does it obscure?) some real problems. One way or another, the turnaround specialist is bound to function as the agent of creditors, not equity. Creditors will quite plausibly conclude that this is just as it should be: after all, it is easy to show how leveraged debtors gamble with creditors' money. Well, indeed they do --- but it is just as easy to show how creditors in trouble will undervalue potential opportunities. In one of my favorite classroom cases, Judge Frank Easterbrook suggests that the real goal of business bankruptcy is to tilt towards neither debt nor equity, but rather towards any strategy that will maximize the value of the asset.[17]

Easterbrook also suggests that the best way to maximize value is to see what the assets will bring at sale, which pretty much brings us back to where we began – chapter 11 as a device, not for giving debtors a second bite, but for facilitating sales.

- A final point regarding "small" chapter 11s. Here, Baird's presentation seems to me to be less helpful, though I am not sure the difficulty is entirely his fault.[18] In any event, unlike the "big" cases, among the "small" cases he seems to have more difficulty finding a common theme.

  I can offer one possibility: incompetence. My friend Janet says her boyfriend likes to give entropy a shove. I wonder if Baird has given adequate consideration to the possibility that many of these small chapter 11s are filed by lawyers with their shoelaces tied together who are lucky to have found the courthouse.

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[17] *See* *In re* Cent. Ice Cream Co., 836 F.2d 1068, 1072 (7th Cir. 1987) (Easterbrook, J.) ("The bankruptcy court should try to implement, rather than alter, non-bankruptcy entitlements."); *cf.* Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127, 128 (1986) ("[T]he entire law of corporate reorganizations is hard to justify under any set of facts and virtually impossible when the debtor is a publicly held corporation."). For a more conventional analysis of director fiduciary duties vis-à-vis creditors, see Helm Fin. Corp. v. MNVA R.R., 212 F.3d 1076, 1083 (8th Cir. 2000), explaining directors breach their fiduciary duty when they use their privileged role in corporation to disadvantage of corporate creditors.

[18] Baird offered a far more extensive treatment of the topic in his oral presentation at the conference.

There is an irony here: in the end, incompetence may be a winning strategy. This arises from a first principle of bankruptcy law: the (insolvent) debtor always gains from more time. Liquidate today and he loses everything, wait until tomorrow and something may turn up.[19]

[19] Perhaps I should have specified "nonrecourse" debt. But this is the situation of any debtor who will get a (personal) discharge in bankruptcy, or of the shareholder in a limited liability company. The rule is not just a rule of thumb, it is a mathematical necessity. It arises from the fact that the debtor's residual stake is an option, and in the master option pricing formula "time" is in the numerator. *See* John D. Ayer, *Maybe I Die, Maybe the King Dies, Maybe a Horse Learns to Talk*, NORTON BANKR. L. ADVISER 9, 9–11 (1996) ("Which brings us back to the heart of the bankruptcy problem. The point is, the debtor always gains from more time."). *See generally* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities* 81 J. POL. ECON. 637 (1973).