

Reorganization By Force

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ABSTRACT

The Bankruptcy Code contemplates the possibility that unsecured creditors can force a company to restructure its financial obligations so that they can get repaid—what’s known as an involuntary chapter 11. Conventional wisdom is skeptical of involuntary chapter 11s. On this view, they undermine the expertise that managers and institutional investors have when it comes to running the company, risking disastrous consequences for the company.

Using five case studies, this Article shows that involuntary chapter 11s can be socially optimal when a company simultaneously faces two kinds of distress: (a) financial distress—proximate threats to the company’s going concern value, such as illiquidity and excessive debt—and (b) managerial distress, where the company’s management is so deadlocked, absent, or otherwise dysfunctional such that it can’t govern the company. When those conditions hold, the company is in jeopardy, but its management is in no position to help, preventing the company from salvaging its going concern value until it’s too late. A part consequently needs to force the company into chapter 11 to resolve both kinds of distress at the same time.

This account has significant implications for what a well calibrated involuntary chapter 11 system would look like. Instead of vindicating unsecured creditors’ desire to get repaid, a sound involuntary chapter 11 regime would encourage investors to force companies facing financial and managerial distress into chapter 11 while disincentivizing parties from filing petitions for companies that face only one, or neither, kind of distress.