Bankruptcy On the Side

Ken Ayotte (U.C. Berkeley)
Tony Casey (U. Chicago)
David Skeel (U. Penn)

What have courts been doing?

- 1. Do not enforce
  - 203 N. LaSalle, Hart Ski
- 2. Enforce the agreement according to its terms
  - Ion Media, Erickson
- 3. Increasingly, lean against enforcement with "clear beyond peradventure" standard
  - Boston Generating, Momentive

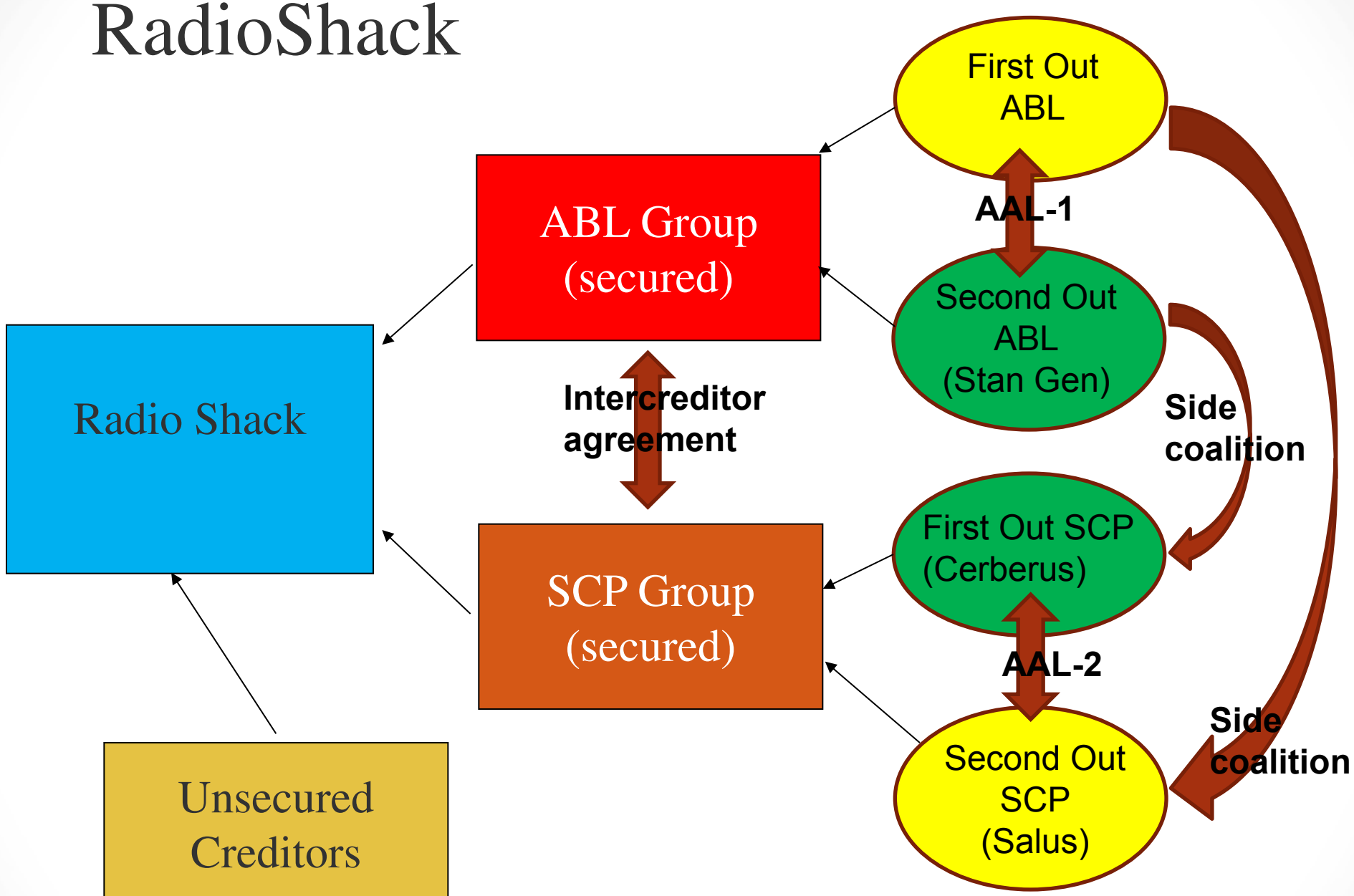
Decisions seem outcome-oriented. Courts seem to rule in way that facilitates a deal

  - Radio Shack

Judge Shannon

“I know your client has rights and I am not trying to really stick anybody, but you have to appreciate how difficult it is to stomach.”

RadioShack


First Out ABL
ABL Group (secured)
AAL-1
Second Out ABL (Stan Gen)
Radio Shack
Intercreditor agreement
Side coalition
First Out SCP (Cerberus)
SCP Group (secured)
AAL-2
Side coalition
Second Out SCP (Salus)
Unsecured Creditors

Two illustrations and our proposal

- Two examples
  - Show intercreditor agreements can be beneficial
  - But can also undermine efficient outcomes
- Key assumptions:
  - Parties can't contract on state of world
  - Junior chooses resolution option
  - Junior can bargain, Senior can't

Example 1: Benefits of side agreements

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
S	120	200	120	200
J	20	0	20	0
C	70	0	10	0
S+J	140	200	140	200
S+J+C	210	200	150	200

Assumptions:

1. Side agreements between S and J are possible. Written to maximize S+J payoff (including any side payments).
2. State of world is not contractible.
3. S cannot negotiate at bankruptcy, but J and C can.
4. Social objective: maximize S+J+C.

Example 1: Benefits of side agreements

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
S	120	200	120	200
J	20	0	20	0
C	70	0	10	0
S+J	140	200	140	200
S+J+C	210	200	150	200

No side agreements:
Expected Outcome = 180

1. J can choose its preferred action.
2. J prefers action R in both states.
3. This makes the S+J coalition worse off in both states
4. Socially, efficient action is chosen in good state but not bad state.

Example 1: Benefits of side agreements

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
S	120	200	120	200
J	20	0	20	0
C	70	0	10	0
S+J	140	200	140	200
S+J+C	210	200	150	200

Specific performance

Expected Outcome = 200

1. J must choose action L.
2. Action L chosen in both states.
3. Socially, efficient action is chosen in bad state but not good state.

Example 1: Benefits of side agreements

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
S	120	200	120	200
J	20	0	20	0
C	70	0	10	0
S+J	140	200	140	200
S+J+C	210	200	150	200

Stipulated damages=90 (Expectation damages =80)

1. J pays damages of 90 (80) for choosing R.
2. In good state, C will pay 70 (60) to J, and J will choose R and pay 90 (80).
3. In bad state, C chooses L.
4. Socially, efficient action is chosen in both states.
5. S+J prefer the SD contract to the SP contract.

Example 2: Side agreements can lead to inefficiencies

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
S	120	200	120	200
J	20	0	20	0
C	100	0	70	0
S+J	140	200	140	200
S+J+C	240	200	210	200

Stipulated damages (120):
Expected Outcome = 220 (S&J get expected value of 220)

Expectation Damages (80):
Expected Outcome = 225 (S&J get expected value of 212.5)

ED is not always efficient

- If S can bargain but J can't, the result is ambiguous
  - SP/SD maximizes C + S (ignores the harms to J) (J under asserts)
  - ED maximizes S + J (ignores harms to C) (J over asserts)
- Ideal solution: court knows
  - 1) ability to bargain/negotiate
  - 2) magnitude of externalities
- Problem: this is usually the same as deciding the whole case

Our approach

- Limit recovery to ED unless externalities are obviously small
- Presumption of ED b/c error costs asymmetric when J can't bargain
  - If allow SP/SD, risk is under-assertion of rights (silencing J)
  - If allow ED, risk is over assertion
    - Courts can fix this (at a small cost)

Consistency with the bankruptcy framework

- Forcing parties to accept ED rather than SP or SD is consistent with the bankruptcy framework
  - Automatic stay (362) prevents removal of asset
- Here, the concern is removing a party rather than an asset from the process

Bankruptcy On the Side

Ken Ayotte (U.C. Berkeley)
Tony Casey (U. Chicago)
David Skeel (U. Penn)

Example 3: Bargaining Matters

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
C1	0	50	0	50
S	210	200	120	200
J	50	0	20	0
S+J	260	250	140	250

But if we change the numbers expectation damages do better.
SP leads to L in good state and L in bad state.
Expectation Damages lead to R in good state and L in bad state.
As long as C and S are bargaining and J cannot bargain, the result is ambiguous.

Example 3: Bargaining Matters

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
C1	0	50	0	50
S	210	200	120	200
J	30	0	20	0
S+J	240	250	140	250

Specific Performance does better here. (L in both states)
Expectation damages lead to R in good state and L in bad state.

[Assuming that damages do not account for side payments]

Example 4: SP can be chosen inefficiently too.

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
C1	0	50	0	50
S	210	200	120	200
J	20	0	20	0
C2	50	0	50	0
S+J	230	200	140	200
C1+S+J+C2	280	250	190	250

New assumptions about bargaining

1. Suppose S can bargain with C1, J and C2 cannot bargain.

Here, it is socially efficient to choose L in bad state, R in good.

Example 4: SP can be chosen inefficiently too.

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
C1	0	50	0	50
S	210	200	120	200
J	20	0	20	0
C2	50	0	50	0
S+J	230	200	140	200
C1+S+J+C2	280	250	190	250

ED will produce efficiency:

1. J will breach in good state and pay no damages (since S is better off under action R). Will not breach in bad state.

Example 4: SP can be chosen inefficiently too.

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
C1	0	50	0	50
S	210	200	120	200
J	20	0	20	0
C2	50	0	50	0
S+J	230	200	140	200
C1+S+J+C2	280	250	190	250

But S+J prefer SP, because it elicits a side payment from C1.

1. In bad state, no side payment from C1.
2. But in good state, C1 bribes S to enforce its right against J. Action L is chosen in good state.
3. Intuition: S+J (partially) internalize effects on parties who can bargain but not effects on parties who can't

Example 4: ED is not perfect

	Good State (p=.5)		Bad State (1-p = .5)	
	R	L	R	L
C1	0	50	0	50
S	210	200	120	200
J	20	0	20	0
C2	15	0	15	0
S+J	230	200	140	200
C1+S+J+C2	245	250	155	250

If we change C2's payoff, S+J write the same contract and take the same actions, but efficiency consequences change.