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The Attack on Chapter 11

Douglass G. Boshkoff

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"After twelve years of experience with the new Bankruptcy Code, people are angry with the bankruptcy process. Creditors are angry with debtors who have resisted payment and thwarted their collection efforts. Employees are angry with companies that have laid them off while the big boys remain in their high paying jobs. Tort victims are angry with companies because they are not getting enough money to compensate them for all that they have lost. Judges are angry with disputants because they have neither the time nor the resources to monitor the cases in their care. And everyone is angry with the lawyers because they are getting rich."

Professor Warren’s bleak appraisal of the situation does not overstate the current crisis of confidence in the American bankruptcy system. Lead stories and editorials in prominent newspapers ("Critics of Bankruptcy Law See Inefficiency and Waste"), "Bankruptcy Needs Reform"), lurid captions over articles in prominent popular publications ("Sharing the World’s Corporate Carrion", "It Pays To Go Broke", "Eastern: The Wings of Greed") and more than enough books with titles such as A Feast for Lawyers: Inside Chapter 11 – An Expose testify to the existence of great public interest in, and concern with, current events in the insolvency world. As the American bankruptcy system approaches its

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8 Americans use the term “bankruptcy” to refer both to proceedings in which individuals obtain a discharge from their obligations and to proceedings in which businesses, large and small, are liquidated or reorganised. One court system, one set of procedural rules, and one substantive law are provided for all financially distressed entities.
100th birthday, it has far more public critics than supporters and much attention has been directed at the business reorganization provisions. A few commentators have even called for repeal of Chapter 11.9

While it is not likely that repeal will occur, some changes in the law can be expected. Before examining proposals for reform, it will be helpful both to review the antecedents of Chapter 11 and to understand the most important aspects of this reorganization process.

I. The antecedents of Chapter 11

The first permanent bankruptcy statute dates from 189810 and contained nothing comparable to today's Chapter 11. Prior to 1933, business reorganizations were accomplished through use of a judicial device, the equity receivership.11 After 1933, various forms of statutory reorganization developed and, by the late 1960s, the most prominent were Chapters X and XI of the 1898 Act.12 Chapter X was designed to address the financial problems of large corporations with publicly held debt or equity securities. Chapter XI provided a simpler procedure for restructuring the affairs of troubled businesses. There were a number of substantive differences between these two chapters, including the fact that management was displaced by an independent trustee only in Chapter X. It was assumed that privately-owned debtors would seek protection under Chapter XI, while debtors with publicly-held debt and equity securities would file under Chapter X. In fact, many publicly owned entities also sought to reorganize under Chapter XI. Since it was sometimes possible to force a transfer from Chapter XI to Chapter X, costly and wasteful litigation challenging management's choice of chapter became common.

By the late 1960s, it was clear that a major revision of our insolvency system was necessary. A Commission on the Bankruptcy Laws of the United States was established in 1970. Three years later, the Commission transmitted its report to Congress. In place of Chapters X and XI, it recommended a single reorganization process, influenced by the fact that Chapter XI was much preferred in practice to Chapter X.

9 Bradley and Rosenzweig, "The Untenable Case for Chapter 11", (1992) 101 Yale LJ 1043 has received the most attention in the national press.
10 Bankruptcy Act of 1898, Ch 541, 30 Stat 544 (repealed 1978).
"Although few statistics are available as to the make-up of Chapter XI cases, it is readily apparent that Chapter XI has evolved into the dominant reorganization vehicle . . .

The reason underlying the preference of lawyers for Chapter XI is obvious, although not often stated. A debtor initiates a Chapter XI proceeding, and only the debtor can propose a plan under Chapter XI. The debtor is normally allowed to operate the business. A concomitant of continued management is the continuation of the employment of the debtor's attorney. On the other hand, if a Chapter X proceeding is initiated, a disinterested trustee is appointed and counsel for the debtor has a greatly reduced function . . . Although proponents of Chapter XI generally talk about speed and economy, control and the "best interest" test obviously are the dominating reasons for the preference. The obvious advantages of Chapter XI to the debtor and his counsel have led to its use by large corporations . . .

It is not feasible to attempt to carve out of Chapter XI certain cases which should be under Chapter X . . . The only solution is an elimination of the disparate procedures. The Commission therefore recommends a comprehensive business reorganization chapter."13

The statute finally adopted by Congress differed in many respects from the Commission proposal. Nonetheless, it retained the proposal that Chapters X and XI be united. The public interest was to be protected through displacement of management by an independent trustee in many large cases.14 Congress did not agree with the Commission's position that a trustee should often be appointed. §1104 of the present statute only authorises the appointment of independent management in a limited set of circumstances.15

The fact that there is no visible change in management upon the commencement of a Chapter 11 case has probably contributed to public distrust of the reorganization process, especially with regard to some prominent national businesses such as Eastern Airlines and Johns-

14 §7–102(a) Bankruptcy Report, pt II, at 221.
16 §1104. Appointment of trustee . . .

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee –

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor; by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
(2) if such appointment is in the interest of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.
Manville. Published accounts of bankruptcy litigation often highlight the fact that the old leadership is still in control. Even so, as we shall later see, current legislative proposals to change the law do not include a provision for routine management displacement.

II. The mechanics of Chapter 11

The American law of bankruptcy is found primarily in Title 11 of the United States Code. This title is divided into eight chapters. Chapters 1, 3 and 5 contain provisions of general application. The remaining chapters authorise one form of liquidation (Chapter 7) and four types of reorganization (Chapters 9, 11, 12 and 13). It is customary to identify a bankruptcy by simply referring to the chapter under which it is commenced.

The proceedings begin with the filing of a petition, usually a voluntary filing by the debtor. Even though the complexity of the Chapter 11 process makes this type of reorganization appropriate only for major business concerns, it is also used by enterprises of modest size. §362 immediately imposes a moratorium (the automatic stay) on all collection activity, including the attempts of secured creditors to realise on their security interests. §362 also authorises the court to grant relief from stay "for cause, including the lack of adequate protection of an interest in property. . . ." Theoretically, the secured party is entitled either to protection against any erosion in the value of its collateral or relief from stay.

In practice, relief from stay is seldom granted if, as is usually the case, the collateral is an essential ingredient of the business enterprise. It is almost impossible to persuade a bankruptcy judge that creditor collection activity should go forward, when the loss of the collateral will prejudice prospects for a reorganization. Instead, the secured party must hope for "adequate protection" which can take various forms including a lien on other assets or court ordered payments to compensate for a possible decline in collateral value.

One shortcoming of adequate protection payments is that they will often not compensate the lender for lost opportunity costs. Let us assume that Creditor has lent Debtor $1,000,000 and has a lien on collateral with a value of only $500,000. After the Chapter 11 petition is filed,

17 11 USC §§301, 303 (1988).
Creditor would like to begin receiving interest for the use of its collateral since it is denied the opportunity to invest elsewhere. But no post-petition interest will accrue\(^2\) until confirmation occurs.\(^2\) In the interim, Creditor is entitled to adequate protection payments only to protect against a decline in the value of the collateral below $500,000.\(^2\)

Equally frustrating for a secured claimant may be the inability to obtain a ruling in its request for relief from the stay. An appeal is not normally possible until the trial court has entered a final order.\(^2\) Congress foresaw the possibility that the bankruptcy judge might wish to forestall appellate review of a ruling against the secured claimant simply by failing to issue a decision on the merits. §362(e)\(^2\) contains detailed procedural rules governing the commencement and conclusion of various stages in the hearing process. The purpose of this provision is to establish an outside limit of 90 days for the issuance of a final (and appealable) decision on the creditor's request. Inexplicably, while authorising both a preliminary and final hearing, the statute fails to supply a date for conclusion of the latter. At one time, a rule of bankruptcy procedure set this deadline. This provision has now been withdrawn,\(^2\) probably because of doubts concerning its validity\(^2\) and the secured creditor cannot force an unwilling judge to a final decision on the merits.

Secured creditors have also been particularly vocal in their criticism of the reorganization process as it applies to "single asset" cases. These cases are essentially real estate bankruptcies in which the debtor's only significant asset is a parcel of real property and the principal claimant is a creditor with a lien on this asset.\(^2\) Much of the criticism is prompted by the lack of compensation for lost opportunity costs and the large amount of time which may pass before the debtor proposes a reorganization plan.

The current statute does not require that a plan be filed by a specific date. Furthermore, only the debtor may propose a reorganization plan during the first 120 days of the reorganization.\(^2\) If a plan is filed within

\(^1\) 11 USC §502(b)(2) (1988) disallows claims for post-petition interest on pre-petition claims.
\(^2\) After confirmation of the plan, the creditor who is denied access to the collateral is entitled to interest on its secured claim ($500,000 in the text hypothetical) or equivalent compensation. 11 USC §1125(b)(2)(A)(i)(II) (1988).
\(^4\) See 1 Lawrence P King, Collier on Bankruptcy, (1993) para 3.03[6].
\(^6\) Lawrence P King, Collier on Bankruptcy (1993) para 4001.04.
\(^7\) See In Re Roberts, 68 BR 1004 (Bankr E D Mich 1987).
\(^8\) Governmental policy, including tax policy, provides incentives for investors to create single-asset entities.
120 days of the petition then the debtor has up to 180 days, again measured from the petition date, to secure the necessary acceptances. This period of exclusivity can be extended or reduced "for cause". In practice, it is routinely and repeatedly extended, sometimes for several years. In the interim, old management usually continues in control and creditors with secured or unsecured claims are held at bay by the automatic stay.

The plan approval process also has generated a great deal of criticism. The statute requires that a proposed plan be accepted by the various affected creditor classes. Acceptances cannot be solicited until the court has approved a disclosure statement. This statement is transmitted to the various classes no later than the time when the plan proponent solicits their favourable votes. Thus, even after a plan has been submitted, further delay is possible until the disclosure statement has been approved.

Chapter 11 provides a legal framework within which bargaining over the terms of a reorganization plan occurs. Most confirmed plans are the result of a negotiating process which requires the consent of all affected classes of creditors and equity interests. Indeed, some criticism of Chapter 11 is directed at the settlement incentives created by the present statutory scheme. Occasionally, a class acceptance cannot be obtained. The statute provides a means for achieving confirmation in such a case. "Cramdown" is the popular term for confirmation of a plan despite the dissent of a class of unsecured claims. Cramdown requires a judicial hearing and cannot occur unless every class below the dissenting class is eliminated (the "absolute priority" rule). Furthermore, every member of each class must receive at least as much as would be received in a liquidation bankruptcy (the "best interest" test).

Assume that a corporation has three ownership classes, unsecured debt, subordinated debt and equity. The absolute priority rule requires elimination of the latter two groups if the unsecured debt does not accept the plan or is not paid or provided for in full. If only the subordinated debt dissents, then the equity must be eliminated. The existence of the absolute priority rule makes it impossible to achieve cramdown in any business where continuation of a subordinate interest is essential.

32 11 USC §1129(a)(8) (1988). Absent consent, confirmation can only be achieved through a difficult and costly process (commonly referred to as "cramdown") prescribed by §1129(b) (1988).
33 11 USC §1125(b) (1988).
35 One objective of American farm policy is to preserve the family farm. Chapter 11 is not a practical alternative for family farm-
plan cannot be negotiated, the business must be liquidated or the Chapter 11 proceeding must be dismissed.

III. The critics

Chapter 11 is under attack from all sides. What follows is a brief description of the major forces driving the current controversy.36

1. The economists

The United States’ Constitution authorises Congress “To establish . . . uniform laws on the subject of Bankruptcies . . .”37 Congress made limited use of this power during the nineteenth century. The Bankruptcy Acts adopted in 1800, 1841 and 1867 were in effect for only short periods of time. Not until 1898, did Congress enact permanent bankruptcy legislation.

In the first half of this century, there was considerable academic interest in establishing the nature of a bankruptcy law.38 Scholars were concerned with two questions: (i) the constitutionality of the statute adopted by Congress, and (ii) the effect of the federal statute upon state statutes which also dealt with insolvency problems. This scholarly interest subsided after the constitutionality of the bankruptcy law had been firmly established and the extent of its pre-emptive effect on state law was clear.

We have recently seen a renewal of academic interest in the essential nature of bankruptcy, particularly in the works of Professor Douglas Baird (University of Chicago) and Thomas Jackson (University of Virginia). Writing both separately and together, Professors Baird and Jackson have argued that bankruptcy exists to solve the problems caused by suboptimal creditor decision-making. In his widely read (and sometimes


37 US Const Art I, §8, cl 4.

reviled) book,39 *The Logic and Limits of Bankruptcy Law,*40 Professor Jackson observes:

"In analyzing bankruptcy law, as with any other body of law, it helps to start by identifying first principles. Those principles can then be developed by defining their potential operation in the existing social, economic, and legal world to identify precisely what bankruptcy law should encompass, how it can accomplish its goals, and the constraints on its ability to do so. That normative view of bankruptcy law can then be contrasted with the Bankruptcy Code as enacted to see whether and to what extent the existing regime follows the path the principles suggest is the proper one.

The point of this book is to suggest what the underpinnings of bankruptcy law should be and then to apply that learning to a variety of issues while testing the current provisions of the Bankruptcy Code against them. This approach is not unique. In fields as disparate and complex as antitrust, oil and gas, intellectual property, and corporate finance, analysis of discrete legal problems usually begins with a look at the theoretical framework that the law is built upon. But this approach is almost unique to bankruptcy law. Much bankruptcy analysis is flawed precisely because it lacks rigor in identifying what is being addressed and why it is a proper concern of bankruptcy law. For that reason, when a new and urgent "problem" is discovered in the context of a bankruptcy proceeding, courts, legislators, and commentators all too often approach its resolution in an ad hoc manner, by viewing bankruptcy law as somehow conflicting with — and perhaps overriding — some other urgent social or economic goal."41

Later in this same book, in a chapter entitled "Reconsidering Reorganizations", Professor Jackson considers the question "Why not eliminate Chapter 11?" and suggests several reasons for doubting that this form of bankruptcy is necessary.42 His colleague, Douglas Baird later went further and suggested how an auction of firm assets might be preferable to current reorganization practice.43 And in another article, Professor

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39 Stan L Rev 1519 contains a more temperate evaluation of Jackson's work.
40 Jackson, *The Logic And Limits of Bankruptcy* (1986).
41 Ibid at 2–3.
42 Ibid at 218–224.
Baird offered these provocative comments on the role of bankruptcy law in contemporary society:

"The existence of our bankruptcy law offers policymakers an opportunity to advance change or reform without squarely debating what they are doing. In a world without bankruptcy, the question of who should have rights to a firm's assets would have to be faced directly. There seems little doubt that Congress could, if it wanted to (and if it acted prospectively), give workers a lien on the assets of a firm or allow firms in financial trouble to repudiate collective bargaining agreements. A law could provide that when any firm liquidated or when its assets were put to a substantially different use, the workers who would lose their jobs as a result would have a right to some fraction of their annual salary, adjusted by the length of their service. Congress could create a regulatory agency and require any firm that wanted to liquidate or change the existing deployment of its assets to go before the agency and make a showing of hardship before implementing its plans. There are any number of other possible laws that might have a similar effect. Such laws may be undesirable for a number of reasons. Other laws might advance the same interests at far less cost. But all of these reforms are possible outside the context of a bankruptcy proceeding. Indeed, they would be possible even if there were no bankruptcy law at all as it is traditionally understood. The justification for preserving the jobs of workers or allowing management to escape from collective bargaining agreements should not be that it vindicates bankruptcy policy, but rather that it is sound policy as a general matter.

We live in a world in which we face many tough issues of social policy and in which we for too long have made altogether casual assumptions about ownership of assets and the priority of these with rights to them. But these issues have nothing to do with bankruptcy law, and we should treat them in our world as we would treat them in a world without bankruptcy."44

Writing jointly and individually, Professors Baird and Jackson have challenged the need for Chapter 11 and have questioned the legitimacy of what goes on during bankruptcy proceedings of all types, including reorganizations. These efforts have provoked an ongoing, often heated, debate about the appropriate objectives of bankruptcy law. Reorganization bankruptcy would probably be under fire today even if this academic team had never published a word. However, Professors Baird and Jackson have created an environment of scepticism in which less theoretical, empirical criticism of bankruptcy, particularly of Chapter 11, receives a great deal of sympathetic attention.

2. The empiricists

In 1992, Michael Bradley of the University of Michigan and Michael Rosenzweig, an Atlanta lawyer, co-authored an article entitled "The Untenable Case for Chapter 11."45 This article was published in the Yale Law Journal, one of the most prestigious scholarly journals in the United States. Bradley and Rosenzweig argued that the new bankruptcy law which became effective in 1979 created incentives for management to remain in control of a financially troubled business while engaging in business activity that was detrimental both to creditors and to the holders of equity interests. They called for the repeal of Chapter 11, arguing that management misbehaviour during reorganizations had increased since the effective date of Chapter 11. And unlike Professors Baird and Jackson, who relied on an elegantly structured theoretical analysis, Bradley and Rosenzweig captured the public's attention with the facts they offered in support of their thesis. As recently as 12 April 1993, their charges were included in a front page story in the New York Times under the headline "Critics of Bankruptcy Law See Inefficiency and Waste."46 Notwithstanding some vigorous criticism of their empirical analysis,47 Bradley and Rosenzweig's thesis will probably remain in the public eye. Legislators and other persons in a position to influence Congressional action are more comfortable with a factual analysis, even if it may be flawed, than with elaborate theoretical arguments.

3. The practitioners

Practitioner criticism of the current statute is often strongly influenced by client base. Lawyers representing secured creditors, unsecured creditors, employees, holders of equity interests all have different views of the reorganization process and seek changes beneficial to their clients.

There is also some criticism from practitioners with less narrowly defined client interests, bankruptcy judges and academics with strong professional ties. These critics tend to be concerned with the high failure rate in Chapter 11,48 the long delay in obtaining confirmation,49 and the poor

45 Bradley and Rosenzweig, supra n 9, at 2.
46 Passell, supra n 2.
48 A 90% failure rate is a common estimate. One recent study concluded that only 6.5% of Chap 11 proceedings resulted in an operating reorganised business. Jensen-Conklin, "Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law", (1992) 97 Comm L J 297, 325.
fit between Chapter 11 and the needs of many businesses. It is generally agreed that Chapter 11 is too costly and cumbersome for many small enterprises. Unfortunately, the other popular reorganization chapter, Chapter 13, has debt limits which are so low that it is not available to many businesses. Today, there is a substantial support for statutory changes which would make it easier to deal with the financial problems of such enterprises. Two types of changes are under consideration: an increase in Chapter 13 debt limits to permit more individual debtors to use this form of reorganization and the creation of a new type of reorganization proceeding specially designed to meet the need of small businesses.

One innovative bankruptcy judge, A. Thomas Small of North Carolina, has already taken concrete action to deal with the delay problem by establishing a "fast-track" reorganization process for small business debtors. As the bankruptcy petitions are filed, certain small businesses are diverted to what Judge Small terms "Chapter 11(a)". As to these cases, Judge Small requires expedited filing of the reorganization plan and the disclosure statement, usually 60 to 90 days after the case is commenced. As long as the disclosure statement is not defective on its face, it is conditionally approved, and the solicitation of votes is permitted. A final hearing on the adequacy of the disclosure statement is held immediately before the confirmation hearing.

Judge Small's procedure reduces delay by speeding up plan filings and by eliminating a step in the confirmation process, the period between the filing of the plan and the disclosure statement hearing. Conversion of the case to a liquidation bankruptcy (Chapter 7) or the appointment of an independent trustee are probable outcomes if the debtor fails to file the necessary documents by the specified date. Judge Small's innovative court procedures have attracted many favourable comments but they have not been widely followed by other judges, possibly because of doubt concerning the statutory authority for fast-track bankruptcies.

729 contains an excellent discussion of the delay problem.
50 Unsecured debt of less than $100,000 and secured debt of less than $350,000. USC §109(e) (1988). Chapter 13 is also available only to individuals. Corporations with any amount of debt are not eligible for this form of bankruptcy.
IV. Pending legislation

There is no legislative support for outright repeal of Chapter 11. However, it is quite possible that Congress will enact reform legislation in the near future. A Bill entitled "The Bankruptcy Amendments Act of 1993"\(^5\) has been introduced in the Senate. Similar legislation passed both Houses of Congress last year, only to fail because final action could not be taken before adjournment.

The legislation now pending in the Senate deals with some of the matters which have irritated critics of Chapter 11. One provision,\(^5\) for example, sets a definite time period for the conclusion of all hearings on a creditor's motion for relief from stay.

Another provision\(^5\) attempts to deal with the problem of delay in obtaining confirmation by controlling excessive extensions of the time within which the debtor enjoys the exclusive right to propose and obtain acceptance of a plan. It sets outer limits on extensions of one year (plan proposal) and 425 days (acceptance) "unless the need for such an increase is attributable to circumstances for which the debtor should not justly be held accountable." It is not clear that this change in language will be effective. Bankruptcy judges today have the power to terminate the exclusive period "for cause" but have generally failed to do so, even though delay has been seen as a significant problem for a long time.\(^5\)

More promising are the provisions\(^5\) which create a new form of reorganization (Chapter 10) for small business debtors with total liabilities not exceeding $2,500,000. Time limits for proposing a plan and obtaining confirmation are reduced in conjunction with a simplification of confirmation requirements. The pending legislation also eliminates the absolute priority rule for debtors filing under Chapter 10. This small business bankruptcy proposal was inspired by Judge Small's "fast-track bankruptcy" although it uses other techniques to speed up the reorganization process.

The Chapter 10 provisions are available only on a limited, experimental basis. Such proceedings are authorised for a period of three years in only eight judicial districts. Presumably, if this new reorganization process proves to be a success, it will be reinstated on a nationwide basis.

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\(^{51}\) S 540, 103rd Cong, 1st Sess (1993).

\(^{52}\) Ibid, §101.

\(^{53}\) Ibid, §102.

\(^{54}\) LoPucki, supra, n 49 at 754.

\(^{55}\) S 540 §201.
The limited availability of Chapter 10 will probably result in a constitutional challenge. The United States' Constitution speaks in terms of a "uniform" bankruptcy law and it is arguable that §201 is invalid because it is not applicable throughout the United States.

The problem of delay in single asset real estate cases has also received special attention. Within 90 days after such a case is commenced, the debtor (i) must have filed a realistic reorganization plan, or (ii) must begin compensating the secured creditor for the opportunity costs associated with the stay of its foreclosure action. Otherwise, a secured creditor is entitled to relief from stay.

One possible statutory amendment is notable for its absence. The pending legislation makes no change in the rule that the pre-bankruptcy management of the debtor remains in control as a "debtor in possession". It may be that continuity of business leadership is not as significant a problem as some critics of Chapter 11 have maintained. It is likely, however, that the retention of control by pre-bankruptcy management in prominent bankruptcies will continue to influence public attitudes toward this type of reorganization.

V. Conclusion

Special interest groups have always, to some extent, influenced the content of bankruptcy legislation in the United States. Lobbying on behalf of such groups has, however, greatly intensified since 1978. Several provisions in the Bankruptcy Amendments Act are controversial because they benefit narrowly defined economic interests. It is possible that these features of the proposed legislation will create a situation in which enactment of any reforms will prove to be impossible.

56 US Const Art I, §8, cl 4.
58 S 540 §202(b).
Even if the pending legislation becomes law in its present form, the attack on Chapter 11 is likely to continue. Nothing in the pending legislation responds to the harshest criticisms of the American reorganization process.