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The Future of Chapter 11

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THE FUTURE OF CHAPTER 11

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I. CHAPTER 11 UNDER ATTACK

A. *Introduction*

When the Bankruptcy Code was enacted in 1978,[1] the wisdom of a bankruptcy reorganization chapter was taken as a given. The crux of the traditional view was summed up in the House Report: "It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets."[2] All that was on the table for serious debate was the particulars.

Today, barely a decade and a half later, the climate of opinion has shifted so dramatically that intelligent people take seriously the suggestion "that Chapter 11 should be repealed."[3] This radical proposal was made in 1992 by Michael Bradley and Michael Rosenzweig in a controversial article in the Yale Law Journal entitled *The Untenable Case for Chapter 11*.[4] And they are not alone.[5] Their article capped a growing trend in the "law and

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1. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988 & Supp. IV 1992) and scattered provisions in U.S.C. tit. 18 and 28).

2. H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

3. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1088-89 (1992).

4. *Id.*

5. Other commentators who have argued for jettisoning Chapter 11, or restructuring it so much that it would bear little resemblance to its current incarnation, include Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) [hereinafter Adler, *Theories*]; Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992) [hereinafter Adler, *Risk Allocation*]; Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992); Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. ECON. 633 (1993) [hereinafter Baird, *Revisiting Auctions*]; Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) [hereinafter Baird, *Reply*]; Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173 (1987) [hereinafter Baird, *World Without Bankruptcy*]; Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986) [hereinafter *Uneasy Case*]; Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); James W. Bowers, *The Fantastic Wisconsylvania Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773 (1993) [hereinafter Bowers, *ZBC School*]; James W. Bowers,

economics" movement that has questioned the justifications for and efficiency of Chapter 11,[6] since at least 1986. In that year, two prominent bankruptcy scholars and frequent co-authors, Thomas Jackson and Douglas Baird, suggested junking Chapter 11 in favor of mandatory sales of the debtor firm's assets.[7]

The Bradley and Rosenzweig article accomplished its goal, if that goal was to provoke controversy. A veritable firestorm of criticism has been leveled at virtually every aspect of their article. The most visible critics of Bradley and Rosenzweig and the staunchest defenders of the traditionalist faith in Chapter 11 have been Elizabeth Warren[8] and Lynn LoPucki.[9] They

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Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution, 26 GA. L. REV. 27 (1991) [hereinafter Bowers, *Loss Distribution*]; James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097 (1990) [hereinafter Bowers, *Groping and Coping*]; THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, ch. 9, *Reconsidering Reorganizations*, 209-24 (1986); Hon. Edith H. Jones, *Chapter 11: A Death Penalty for Creditor Interests*, 77 CORNELL L. REV. 1088 (1992); Robert K. Rasmussen, *Debtor's Choice: a Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 1 (1992) [hereinafter Rasmussen, *Debtor's Choice*]; Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319 (1991) [hereinafter Rasmussen, *Efficiency*]; Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

6. The generally applicable provisions of "Chapter 11," the single reorganization chapter of the Code, are found at 11 U.S.C. §§ 1101-1146 (1988).

7. *See* Baird, *Uneasy Case, supra* note 5; JACKSON, *supra* note 5, at 209-24. Jackson could be viewed as the founding father of the economic school as applied to bankruptcy theory, with his seminal 1982 article, Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

8. Elizabeth Warren, *The Untenable Case for the Repeal of Chapter 11*, 102 YALE L.J. 437 (1992) [hereinafter Warren, *Untenable Case*]; *see also* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World,* 92 MICH. L. REV. 336 (1993) [hereinafter Warren, *Bankruptcy Policymaking*]; Elizabeth Warren, "*Why Have a Federal Bankruptcy System?*", 77 CORNELL L. REV. 1093 (1992) [hereinafter Warren, *Why Have?*]; Elizabeth Warren, *Bankruptcy Policy,* 54 U. CHI. L. REV. 775 (1987) [hereinafter Warren, *Bankruptcy Policy*].

9. Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig,* 91 MICH. L. REV. 79 (1992) [hereinafter LoPucki, *Strange Visions*].

Professor LoPucki co-authored a series of articles with Professor William Whitford, discussing and analyzing their findings in a massive study of the bankruptcy reorganizations of large, publicly held companies. *See* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597 (1993) [hereinafter LoPucki & Whitford, *Patterns*]; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*]; Lynn M. LoPucki & William C.

too have their spiritual allies.[10] But even in this camp, clouds can be seen on the horizon. LoPucki, who has assailed Bradley and Rosenzweig,[11] has himself written an article called *The Trouble with Chapter 11.*[12]

Criticism of Chapter 11 has not been limited to the groves of academe. Judge Edith Jones, a well-known federal judge who by popular accounts was the runner-up to Justice David Souter for a seat on the Supreme Court, has called Chapter 11 "A death penalty for debtor and creditor interests."[13] Leonard Rosen, a prominent corporate reorganization lawyer from New York City and president of the National Bankruptcy Conference, has stated in print that "chapter 11 needs a rewrite."[14] A widely published weekly bankruptcy newsletter has asked "What's wrong with chapter 11?"[15] Many

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Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11 [hereinafter LoPucki & Whitford, *Venue Choice*]; Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990) [hereinafter LoPucki & Whitford, *Equity's Share*].

The same two authors also wrote an interesting piece advocating a reform of the cram-down procedures. Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625 (1991) [hereinafter LoPucki & Whitford, *Preemptive Cram Down*].

10. *See* Edward I. Altman, *Evaluating the Chapter 11 Bankruptcy-Reorganization Process,* 1993 COLUM. BUS. L. REV. 1; Jagdeep S. Bhandari & Lawrence A. Weiss, *The Untenable Case for Chapter 11: A Review of the Evidence*, 67 AM. BANKR. L.J. 131 (1993); Hon. Lisa H. Fenning, *The Future of Chapter 11: One View From the Bench,* 1993-1994 ANN. SURV. BANKR. L. 113; Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig,* 78 IOWA L. REV. 669 (1993) [hereinafter Korobkin, *Unwarranted Case*]; Donald R. Korobkin, *Rehabilitating Values: a Jurisprudence of Bankruptcy,* 91 COLUM. L. REV. 717 (1991) [hereinafter Korobkin, *Rehabilitating Values*]; Marvin J. Whitman et al., *A Rejoinder to "The Untenable Case for Chapter 11,"* 2 J. BANKR. L. & PRAC. 839 (1993). Professor David Skeel has reviewed the many current theories and found each wanting in some manner or another, including the Bradley and Rosenzweig hypothesis. David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory,* 1993 WIS. L. REV. 465. Mark MacDonald and others have published a provocative piece describing Chapter 11 as a "living entity." Mark E. MacDonald et al., *Chapter 11 as a Dynamic Evolutionary Learning Process in a Market With Fuzzy Values,* 1993-1994 ANN. SURV. BANKR. L. 1 (1993). A somewhat surprising supporter of Chapter 11 is Judge Frank Easterbrook, who definitely belongs in the law and economics camp, but who argues that Chapter 11 must be efficient or it would not exist. Hon. Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?* 27 J. FIN. ECON. 411 (1990).

11. *See* LoPucki, *Strange Visions, supra* note 9.

12. Lynn M. LoPucki, *The Trouble With Chapter 11,* 1993 WIS. L. REV. 729.

13. *See* Jones, *supra* note 5.

14. Leonard M. Rosen, *Book, Chapter and Worse: Chapter 11 Needs a Rewrite,* BUS. L. TODAY, July-Aug. 1992, at 47.

15. *The Debate Continues: What's Wrong with Chapter 11?,* 23 Bankr. Ct. Dec.

chroniclers in the popular press have raised questions about the bankruptcy system and Chapter 11.[16] Several books have been published levelling broadsides at the Chapter 11 process generally and at particular cases perceived as abusive.[17]

B. The Origins and Substance of the Criticism

Why is everybody picking on Chapter 11 all of a sudden? The flood of criticism of Chapter 11 is a result of a confluence of factors. Esoteric academic suggestions that received little public attention in 1986[18] made front page news in 1992.[19]

A major catalyst behind the outcry undoubtedly has been a series of highly publicized and criticized Chapter 11 cases. Whether right or wrong, the perception of many has been that these companies attempted to use

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(CRR) at A1 (Nov. 5, 1992) [hereinafter *What's Wrong?*].

16. *Bankruptcy Needs Reform,* N.Y. TIMES, Apr. 14, 1993, at A14 [hereinafter *Reform*]; *Chapter 11: A Costly Solution,* DUN'S BUS. MONTH, Nov. 1983, at 25 [hereinafter *Costly Solution*]; Tom Furlong, *A Bankrupt System: The Southland's Troubled Bankruptcy Courts,* L.A. TIMES, Jan. 13, 1992, at A1; John Greenwald, *The Bankruptcy Game,* TIME, May 18, 1992, at 60; Doug Henwood, *Failures in the System: Behind the Bankruptcy Boom,* NATION, Oct. 5, 1992; Kenneth Jost, *Chapter 11 Under Fire,* A.B.A.J., July 1992, at 32; Wade Lambert & Milo Geyelin, *Bankruptcy Lawyers Dispute Call for Scrapping Chapter 11 Process,* WALL ST. J., Mar. 19, 1992, at B6; Andrea Orr, *"Chapter 22" Filings on the Rise,* CHI. TRIB., July 7, 1991, at A7; Peter Passell, *Critics of Bankruptcy Law See Inefficiency and Waste,* N.Y. TIMES, Apr. 12, 1993, at A1; Michelle Singletary, *Critics Urge Bankruptcy Law Reform,* WASH. POST, Nov. 29, 1992, at A25; *The Uses and Abuses of Chapter 11,* ECONOMIST, Mar. 18, 1989, at 72 [hereinafter *Uses and Abuses*]; Donald B. Thompson, *A Strategy of Choice; Chapter 11: An Offensive Weapon?,* INDUS. WK., Aug. 4, 1986, at 16; Pat Wechsler, *Chapter 11 Attacked as too Soft, Critics Say it Allows Management to Feed off Company's Creditors,* S.F. CHRON., May 9, 1992, at B3 [hereinafter Wechsler, *Too Soft*]; Pat Wechsler, *Chapter 11: Money to Burn? Critics Say Bankruptcy Gives License to Bad Managers who Fritter away Assets,* NEWSDAY, Mar. 22, 1992, at 72 [hereinafter Wechsler, *Money to Burn?*]; Pat Wechsler, *Is it Time to Close the Book on Chapter 11?,* PHILADELPHIA INQUIRER, Mar. 29, 1992, at D1 [hereinafter, Wechsler *Close the Book*]; *When Firms Go Bust,* ECONOMIST, Aug. 1, 1992, at 63 [hereinafter *Go Bust*]; Stanley Ziemba, *Bankruptcy Law Unfair: United Chief,* CHI. TRIB., Feb. 18, 1993, at B1.

17. *See, e.g.,* KEVIN J. DELANEY, STRATEGIC BANKRUPTCY: HOW CORPORATIONS AND CREDITORS USE CHAPTER 11 TO THEIR ADVANTAGE (1992); LAURENCE H. KALLEN, CORPORATE WELFARE: THE MEGABANKRUPTCIES OF THE 80S AND 90S (1991); RICHARD B. SOBOL, BENDING THE LAW: THE STORY OF THE DALKON SHIELD BANKRUPTCY (1991); SOL STEIN, A FEAST FOR LAWYERS—INSIDE CHAPTER 11: AN EXPOSE (1989).

18. *See* Baird, *Uneasy Case, supra* note 5; JACKSON, *supra* note 5.

19. Skeel, *supra* note 10, at 466-67; *see* Bradley & Rosenzweig, *supra* note 3.

Chapter 11 for illicit purposes: Robins, which tried to shed its Dalkon Shield liability;[20] Manville, which did the same for mass asbestos claims;[21] union-busting cases, such as Continental Airlines, Wilson Foods, and Bildisco;[22] LTV, which tried to escape pension obligations to retirees;[23] and Texaco, which used Chapter 11 to try to avoid an enormous state-court judgment in favor of Pennzoil.[24] At a minimum, observers recognized that the bankruptcy court had become "the forum where large, complex cases often involving social issues are being handled."[25]

The final straw was the disastrous Eastern Airlines case.[26] First, that case captured notoriety as another of Frank Lorenzo's anti-union assaults. Then, even after the creditors had given up on the business, the bankruptcy judge allowed Eastern to waste several hundred million dollars more, before the final liquidation occurred. After Eastern, the crusade against Chapter 11 really picked up steam. Critics had ready grist for their mill.

At the same time that these notorious cases captivated the attention of

20. For the most in-depth study and critique of the Robins bankruptcy, see SOBOL, *supra* note 17. For another fusillade at Robins, *see* KALLEN, *supra* note 17, ch. 12, *Robins Becomes a Prisoner of its Own Device,* at 303-47, and ch. 13, *A Toxic Tortfeasor Dives for the Bankruptcy Bunker,* at 348-83; *see also* Passell, *supra* note 16, at A1; *Uses and Abuses, supra* note 16, at 72.

21. *See* DELANEY, *supra* note 17, ch. 3, *The Manville Corporation: Solving Asbestos Liability Through Bankruptcy,* at 60-81; KALLEN, *supra* note 17, ch. 9, *Manville: The Giant at Bay,* at 225-47, ch. 10, *Stalemate,* at 248-74, ch. 11, *In Silverman We Trust,* at 275-302; Greenwald, *supra* note 16, at 60; Passell, *supra* note 16, at A1; *Uses and Abuses, supra* note 16, at 72.

22. *See* DELANEY, *supra* note 17, ch. 4, *Continental Airlines: Using Bankruptcy to Abrogate Union Contracts,* at 82-125; KALLEN, *supra* note 17, ch. 8, *Boffo Battle: Big Business in Bankruptcy Busts Brotherhoods,* at 203-24; Greenwald, *supra* note 16, at 60; Jost, *supra* note 16, at 32; Passell, *supra* note 16, at A1; Wechsler, *Too Soft, supra* note 16, at B3; *Uses and Abuses, supra* note 16, at 72.

23. *See* 138 CONG. REC. S8268 (daily ed. June 16, 1992) (remarks of Sen. Graham); *see also* KALLEN, *supra* note 17, at 388-92; Thompson, *supra* note 16, at 16; Wechsler, *Money to Burn?, supra* note 16, at 72.

24. *See* DELANEY, *supra* note 17, ch. 5, *Texaco: Using Bankruptcy to Frustrate a Business Rival,* at 126-59; KALLEN, *supra* note 17, at 394-405; *Uses and Abuses, supra* note 16, at 72.

25. 138 CONG. REC. S8335 (daily ed. June 17, 1992) (remarks of Sen. Sanford). Senator Sanford went on to add, "We are seeing large judgments, mass tort claims, pension shortages, labor disputes, and a host of other problems being played out in the Bankruptcy Court." *Id.*

26. *See* KALLEN, *supra* note 17, at 405-12; Michael Bradley & Michael Rosenzweig, *Time to Scuttle Chapter 11,* N.Y. TIMES, Mar. 8, 1992, § F (Forum), at 13; Rasmussen, *Efficiency, supra* note 5, at 319-21; Skeel, *supra* note 10, at 467; Greenwald, *supra* note 16, at 60; Passell, *supra* note 16, at C9; Wechsler, *Money to Burn?, supra* note 16, at 72.

an ever-more distrusting public, the savings and loan crisis exploded, with an attendant collapse in real estate values. The enormous Southmark case typified this problem.[27] Part and parcel of this whole disaster was the leveraged buyout craze of the 1980s, which inevitably, it seems, crashed into the reorganization court.[28] Revco and Federated provide examples of LBOs reworked in reorganization court, with bondholders left out in the cold. Chapter 11, it seemed, let the responsible parties off the hook. Michael Miliken and the Drexel Burnham Lambert case effectively symbolized the problem.[29] What one congressman called "financial shenanigans"[30] should not be countenanced.

An ideological war was also developing. The advocates of right-wing free-market economics attacked Chapter 11 as an inefficient tool for propping up weak companies in the interest of misguided warm and fuzzy notions about preserving jobs and communities.[31] If a company cannot pay its debts, let the creditors foreclose, and be done with it. In a nutshell, that is the Bradley and Rosenzweig proposal.[32] Furthermore, those critics asserted that Chapter 11 should not be used to redistribute losses.[33] The solution? Rely on markets.[34]

On the other side, Chapter 11 has been viewed as too supportive of greedy heartless capitalists. Mass tort victims—too bad.[35] Organized labor—good riddance.[36] When a congressman uses the term "economic criminals" in connection with a bankruptcy reform bill,[37] it is time to wake

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27. *See* KALLEN, *supra* note 17, at 416-17.

28. *See* 138 CONG. REC. H11,056 (daily ed. Oct. 3, 1992) (remarks of Rep. Brooks); *see also* KALLEN, *supra* note 17, at 433-46; Greenwald, *supra* note 16, at 61.

29. *See* KALLEN, *supra* note 17, at 434-39; Henwood, *supra* note 16, at 364.

30. 138 CONG. REC. H11,058 (daily ed. Oct. 3, 1992) (remarks of Rep. Glickman).

31. *See* JACKSON, *supra* note 5, at 210; KALLEN, *supra* note 17, at 468; Baird, *Reply, supra* note 5, at 828-31; Baird, *World Without Bankruptcy, supra* note 5, at 184-86; Bowers. *Loss Distribution, supra* note 5, at 69-76; Jones, *supra* note 5, at 1090-91; Rasmussen, *Efficiency, supra* note 5, at 324; *see also* Henwood, *supra* note 16, at 362-64 (describing but disagreeing with the free-market theory).

32. *See* Bradley & Rosenzweig, *supra* note 3, at 1078-88; Bradley & Rosenzweig, *supra* note 26, at 13.

33. *See* Adler, *Risk Allocation, supra* note 5, at 489; Baird, *Reply, supra* note 5, at 822-28.

34. *See* Bradley & Rosenzweig, *supra* note 3, at 1085; Bradley & Rosenzweig, *supra* note 26, at 13.

35. *See, e.g.,* A.H. Robins, *discussed supra* note 20 and accompanying text; Johns-Manville, *discussed supra* note 21 and accompanying text.

36. *See, e.g.,* Continental Airlines, Wilson Foods, Bildisco, *discussed supra* note 22.

37. 138 CONG. REC. H11,058 (daily ed. Oct. 3, 1992) (remarks of Rep. Dreier): "Good businessmen and women are losing out to a wave of *economic criminals* who have been using the bankruptcy system to delay and defraud their creditors." (emphasis

up and realize that people are upset. The supposed winners? Corporate managers keeping their jobs and obscene salaries despite poor performance, and hordes of lawyers sucking enormous fees out of the bankruptcy system.[38] Senator Metzenbaum has convened hearings to probe the problem of excessive professional fees.[39] Chapter 11 has been called "A Feast for Lawyers."[40]

In this charged setting, it became easy to pick on the recently adopted Bankruptcy Code. Critics point to the large increase in the number of filings since the Code went into effect in 1979,[41] suggesting that the reason was the suddenly more favorable law.[42] Where only 7,827 Chapter 11 cases were filed in SY 1981, the first full year under the Code, filings almost tripled over the next two years, to 21,206 in SY 1983, and reached 24,209 in SY 1992.[43] As is often true, however, hysteria does not always consider the facts: this "excessive" number of 24,000 Chapter 11 filings represented just a fourth of the total business failures in 1992.[44] Furthermore, evidence

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added).

38. *See* Bradley & Rosenzweig, *supra* note 3, at 1076-77; Bradley & Rosenzweig, *supra* note 26, at 13; Furlong, *supra* note 16, at A1; Greenwald, *supra* note 16, at 60, 61; Passell, *supra* note 16, at A1.

39. Senator Metzenbaum described the situation as a "feeding frenzy" in which "professionals literally suck the life out of a bankrupt company by charging exorbitant and in many cases unnecessary fees." 138 CONG. REC. S8340 (daily ed. June 17, 1992) (remarks of Sen. Metzenbaum).

40. STEIN, *supra* note 17.

41. *See* 138 CONG. REC. H11,056 (daily ed. Oct. 3, 1992) (remarks of Rep. Fish); 137 CONG. REC. S17,047 (daily ed. Nov. 19, 1991) (remarks of Sen. Heflin) (pointing to "nearly a threefold increase in filings in little more than a decade" as "significant warnings" that warranted "a significant review of the bankruptcy system"); 137 CONG. REC. S17,056 (daily ed. Nov. 19, 1991) (remarks of Sen. Grassley) (describing "bankruptcy boom" and calling bankruptcy a "growth industry").

42. However, rigorous econometric studies that go beyond "armchair empiricism" raise serious doubts as to whether the increased filing rate can be attributed to the change in the bankruptcy law. *See* Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: An Historical Analysis*, 67 AM. BANKR. L.J. 1, 11-12 (1993).

43. These statistics are published as *Bankruptcy Statistical Information* by the Administrative Office of the U.S. Courts, for statistical years running from July 1 to June 30. The 1992 statistic is reprinted in Press Release (Am. Bankr. Inst., Washington, D.C.), Sept. 3, 1992, T. F-2, at 4.

44. DUN & BRADSTREET CORP., 1991-1992 BUS. FAILURE REC. 2 (1992) indicates that 96,587 businesses failed in 1992. By comparison, only 7,564 failures occurred in 1979—only about 8% of the 1992 total; viewed otherwise, there was a thirteenfold increase in failures from 1979 to 1992. Chapter 11 filings, on the other hand, only tripled during the same period. Thus, it appears that the "Code-made-them-file" theory is false, and if anything, far fewer businesses, as a percentage of total business failures, are filing Chapter 11. These data suggest that general economic conditions, not the Code,

indicates that filings have begun to drop from the 1992 levels.[45]

Studies also have raised questions about the large costs of Chapter 11, direct and indirect. One oft-cited example is the fact that the combined value of Texaco and Pennzoil stock rose by $2.3 billion with the announcement that they had reached a settlement and that Texaco would be leaving Chapter 11.[46] The conclusion drawn was that investors must have projected a deadweight cost of $2.3 billion from Texaco's bankruptcy case.[47] Other studies have estimated direct costs in Chapter 11 ranging from three to six percent of the company's assets.[48]

And there is more fuel for the fire of criticism. The 1989 study done by the Administrative Office of the U.S. Courts estimated that only about ten percent of all Chapter 11 cases succeed in rehabilitating the debtor firm.[49] However, the rate of success for large, publicly held firms is much higher.[50] Another stated concern is that many debtors (Continental, Braniff, etc.) revisit Chapter 11—the "serial" filing problem;[51] or, stated otherwise, there is a disturbingly "high rate of recidivism."[52] One study found that a little more than half (58%) of confirmed plans in the test district were successfully consummated.[53]

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have been the culprit behind the filing boom.

45. Ed Flynn, *Bankruptcy Filings Continue to Decrease in 1993*, AM. BANKR. INST. J., Oct. 1993, at 11.

46. Robert H. Mnookin & Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding* Pennzoil v. Texaco, 75 VA. L. REV. 295, 299 (1989).

47. Adler, *Risk Allocation, supra* note 5, at 466.

48. *See id.* at 465 & n.107; Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1077 (1984) (six percent); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 289-90 (1990) (three percent).

49. Ed Flynn, Statistical Analysis of Chapter 11, at 13 (Administrative Office for the U.S. Courts, Bankruptcy Division, Oct. 1989) (unpublished paper, on file with author). Flynn arrived at this conclusion based on the empirical study for cases through 1986, which showed (1) a confirmation rate of about 17%, and (2) that about one-fourth of these were liquidating plans, and then (3) factored in the possibility of subsequent bankruptcies. *Id.* at 10-13. Flynn found that the success rate had increased. *See also* Bradley & Rosenzweig, *supra* note 3, at 1075 & n.75; Jones, *supra* note 5, at 1089; Rasmussen, *Efficiency, supra* note 5, at 322.

50. *See* LoPucki & Whitford, *Patterns, supra* note 9, at 600-01; *see also* Altman, *supra* note 10, at 5-6.

51. *See* Altman, *supra* note 10, at 6; Jones, *supra* note 5, at 1091; Orr, *supra* note 16.

52. LoPucki, *supra* note 12, at 731 & n. 9 (thirty-two percent rate for large, publicly held companies); *see also* LoPucki & Whitford, *Patterns, supra* note 9, at 608.

53. Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297, 324 (1992).

Other studies indicate that the average time a debtor spends in Chapter 11 has increased significantly under the Code.[54] While exact figures vary, most studies find an average Chapter 11 sojourn (to confirmation) of one-and-a-half to two years.[55] Time increases costs, both directly and indirectly, and results in wealth transfers.[56]

In summary, then, the charges against Chapter 11 basically are as follows:

- too many debtors use Chapter 11;
- Chapter 11 is being used for illegitimate reasons;
- managers and lawyers are milking Chapter 11;
- too many Chapter 11 cases fail;
- Chapter 11 cases cost too much;
- Chapter 11 cases take too long; and
- unwarranted redistributional effects occur in Chapter 11.

C. *Prospects for Reform*

So what is going to happen? When a notion gains popular currency, as has the refrain that "Chapter 11 is in trouble," it could lead to some form of concrete action. Commissions will be appointed, hearings will be held, studies will be conducted, and, finally, laws may be passed. And articles like this will be written. Our society believes that we can fix anything through the provident exercise of governmental power. This general premise certainly holds true in the field of bankruptcy law. Every forty years since 1898, Congress has thoroughly revised the bankruptcy laws after years of study, and then immediately undertaken to make that law "better" via endless amendments. If people are generally upset about the state of the bankruptcy system—and they are—then Congress may well pass some laws to "correct" the problems.

Indeed, in 1992 Congress came close to passing a major bankruptcy reform bill. Senate bill S. 1985,[57] introduced as a bipartisan bill by Senators Heflin and Grassley,[58] passed the Senate unanimously.[59] Along

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54. *See* LoPucki, *supra* note 12, at 739-45 (describing results of various studies); *see also* Altman, *supra* note 10, at 3-4.

55. *See* Flynn, *supra* note 49, at 24 (mean time from filing to confirmation: 740 days; median time: 656 days); *see also* LoPucki, *supra* note 12, at 739-45 (summarizing different studies); *What's Wrong?, supra* note 15, at A6 (Prof. LoPucki stating that average time in Chapter 11 for smaller debtors has gone from eight months to eighteen months under Code).

56. *See* LoPucki, *supra* note 12, at 732-39.

57. S. 1985, 102d Cong., 2d Sess. (1992), *reprinted in* [CCH Special 2] Bankr. L. Rep. (CCH), No. 337, at 1 (July 2, 1992) [hereinafter S. 1985, *Passed Version*].

58. 137 CONG. REC. S17,047 (daily ed. Nov. 19, 1991) (remarks of Sen. Heflin, for

with numerous specific amendments to the Code, that bill would have created a National Bankruptcy Review Commission to study the Code for two years.[60] Although S. 1985 was modified in many respects as it went through the House[61] and then through conference,[62] the provision for a Review Commission survived in the final conference version of the bill.[63] S. 1985 has been resurrected in the 103d Congress as S. 540,[64] which again provides for a Review Commission.[65]

The ultimate fate of this and other proposed reforms depends of course on the House, which seems to have less passion for immediate bankruptcy reform than the Senate, and on the President. Some of the proposals in the Senate legislation are noteworthy. To give but one example, S. 1985 as passed by the Senate[66] and now S. 540[67] provide for a new small business chapter, Chapter 10, on a pilot district basis. The hope is that small businesses (defined as having debts of less than \$2.5 million)[68] can be

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himself and Sen. Grassley).

59. 138 CONG. REC. S8331 (daily ed. June 17, 1992).

60. S. 1985, *Passed Version, supra* note 57, tit. I, §§ 101-110.

61. H.R. 6020, 102d Cong., 2d Sess. (1992) passed the House on October 3, 1992 and was made a part of S. 1985 at the request of the House. 138 CONG. REC. H11,052 (daily ed. Oct. 3, 1992). Senator Heflin noted that the bill that passed the House was "considerably different" from the one that passed the Senate. 139 CONG. REC. S2610 (daily ed. Mar. 10, 1993) (remarks of Sen. Heflin).

62. As Senator Heflin explained in introducing S. 540 in 1993, S. 1985 as modified by an informal conference was approved by the Senate but was not passed on by the House because of "dilatory tactics . . . regarding all legislation." 139 CONG. REC. S2611 (Mar. 10, 1993) (remarks of Sen. Heflin).

63. The final version of the bill is S. 1985, version 6 (Oct. 23, 1992) [hereinafter S. 1985, *Final Version*]. In this final version, the provision for the Bankruptcy Review Commission had been moved from title I to title V, §§ 501-510.

64. S. 540, 103d Cong., 1st Sess. (1993), *reprinted in* [CCH Special 1] Bankr. L. Rep. (CCH) No. 356, at 1 (Mar. 26, 1993) [hereinafter S. 540, *Introduced Version*]. Senator Heflin, in introducing S. 540, emphasized that it is "very similar" to the version of S. 1985 that passed the Senate in 1992. 139 CONG. REC. S2610 (daily ed. Mar. 10, 1993) (remarks of Sen.. Heflin). The Senate Judiciary Committee reported out an amendment in the nature of a substitute. SEN. COMM. ON JUDICIARY, OMNIBUS BANKRUPTCY REFORM LEGISLATION, S. REP. NO. 168, 103d Cong., 1st Sess. 39 (1993). The text of S. 540 as reported is found at *id.* 1-38 [hereinafter S. 540, *Reported Version*].

65. S. 540, *Reported Version, supra* note 64, tit. IV, §§ 401-410.

66. S. 1985, *Passed Version, supra* note 57, § 205.

67. S. 540, *Reported Version, supra* note 64, § 201.

68. *Id.* § 201(a) (defining "small business" as "a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate liquidated secured and unsecured debts as of the date of the petition do not exceed

reorganized more quickly and cheaply if relieved from complying with the rigorous procedures of Chapter 11.[69] However, in 1992 Chapter 10 did not survive to the final conference version;[70] whether it will make it through in the 103d Congress is hard to predict.

At this juncture, with the winds of reform in the air, those interested in the bankruptcy system—lawyers, judges, professors—need to participate in the debate about the future of Chapter 11. That is the focus of this article.

II. FIRST PRINCIPLES: WHY CHAPTER 11?

In assessing "the future of Chapter 11," it is important initially to focus on first principles. We need a reference point. If people say Chapter 11 is not working, there must be some notion that it is not working in comparison to some perceived ideal. What is that ideal of Chapter 11? Why do we have Chapter 11 at all?

It would be an understatement to note that not everyone agrees on what the fundamental purposes of the corporate reorganization chapter of the Bankruptcy Code are or should be. Having said that, until fairly recently there was a relatively strong consensus as to why we have Chapter 11. The 1977 House Report summarizes the essence of that consensus:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.[71]

Professors LoPucki and Whitford have observed that "[t]he existence of bankruptcy reorganization procedures is commonly premised on the existence of a difference between the going concern value of the firm and its liquidation value."[72] Professor Warren has summarized the so-called "traditionalist" theory of corporate reorganization, finding that four primary goals dominate: "(1) to enhance the value of the failing debtor; (2) to distribute value according to multiple normative principles; (3) to internalize

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$2,500,000").

69. S. REP. NO. 168, *supra* note 64, at 39, 43.

70. S. 1985, *Final Version, supra* note 63.

71. *See* H.R. REP. NO. 595, *supra* note 2, at 220, *reprinted in* 1978 U.S.C.C.A.N. at 6179.

72. LoPucki & Whitford, *Corporate Governance, supra* note 9, at 758.

the costs of the business failure to the parties dealing with the debtor; and (4) to create reliance on private monitoring."[73]

This idea that the preservation of a business as a going concern is better for everyone—creditors, stockholders, bondholders, employees, and the public generally—is not a new one. It has been around for at least a century, really ever since the Industrial Revolution reached full flower. Reorganizations were first developed in earnest in the late nineteenth century as a way of keeping the railroads running. The mechanism used was the equity receivership.[74] Eventually, as more private corporations sought to reorganize, and as the Great Depression hit, the weaknesses in the equity receivership became increasingly apparent, momentum to enact a statutory corporate reorganization law became overwhelming, and the laws were passed.[75]

Looking at some of the comments made back in the 1930s, at the time section 77B and then Chapters X and XI were enacted, is instructive for us today. Those voices from the past serve as useful rejoinders to some of the more radical suggestions now being made that Chapter 11 should be sacrificed on the altar of perfect markets.[76] If we forget the past, are we doomed to repeat it? To give one example, John Gerdes, a noted corporate reorganization lawyer and lecturer on corporate reorganizations at NYU, observed in 1936:

> The solvency or insolvency of a "big" corporation, having thousands of stockholders, owning and operating property throughout the world, and employing a veritable army of workers, is a matter of importance to the entire nation. The well-being of such a corporation makes its mark upon the prosperity of the

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73. Warren, *Bankruptcy Policymaking, supra* note 8, at 344. In an earlier article, Professor Warren observed, "I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors." Warren, *Bankruptcy Policy, supra* note 8, at 777. Later in that article, in an oft-quoted statement, she concluded, "I have offered a dirty, complex, elastic, interconnected view of bankruptcy from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision." *Id.* at 811. More recently, responding to Bradley and Rosenzweig, she noted, "The Code is thus designed not only to enhance the value of the failing business, but also to distribute that value among interested parties in specified ways." Warren, *Untenable Case, supra* note 8, at 468.

74. REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE U.S., H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt.1, at 238-39 (1973) [hereinafter COMMISSION REPORT].

75. *Id.*

76. *See, e.g.*, Adler, *Risk Allocation, supra* note 5, at 489; Bradley & Rosenzweig, *supra* note 3, at 1078.

> country; the closing of its plants is a major catastrophe in the lives of hundreds, often thousands, of employees; its continuation in business is an item of public concern.[77]

Today, Elizabeth Warren echoes Gerdes: "The bankruptcy system matters. It mattered to a $10 billion business like Federated, and it mattered to their 80,000 employees who stayed on the job."[78]
Gerdes went on to note: "The properties of a corporation have a maximum value as parts of an aggregate unit continuing as a going concern. . . . Only by keeping the properties together and by continuing the operation of the business can the maximum value of the corporate property be maintained."[79]

Point one, then, is that a business is worth more alive than dead—*i.e.*, it is worth more as a going concern than in a forced sale liquidation; and that all affected parties, defined broadly, benefit if that going concern is maintained. Along these lines, it is worth remembering that more than just the private rights of the creditors and debtor may be implicated; the greater good of the community at large has always been considered, and rightly so, relevant to the formulation of bankruptcy policy.[80]

It should be borne in mind that the foregoing conclusion is not a result of purely academic conjecture. Indeed, the truth is quite the opposite; it is what parties in fact do. When a business becomes financially distressed, the first order of business for the company and its creditors and stockholders is to try to put together a consensual workout.[81] Studies have shown that about half of the business reorganizations effectuated today are done out of court, by voluntary agreement.[82] Thus, it is only when an out-of-court workout cannot be achieved that the need for some other means of business

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77. 1 JOHN GERDES, CORPORATE REORGANIZATIONS UNDER § 77B OF THE BANKRUPTCY ACT § 1, at 2-3 (1936).

78. Warren, *Untenable Case, supra* note 8, at 478.

79. GERDES, *supra* note 77, § 1, at 3-4.

80. Back in 1919, a commentator remarked that a creditor's "rights are partially offset by the paramount rights of the community. A private right must always give place to a general good." F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY LAW 191 (1919).

Today, along with Professor Warren, Professor Karen Gross is perhaps the leading advocate of the need to take the "public interest" into account explicitly as a basis of reorganization policy. She has suggested that § 1129 should require the court to consider the public interest as a condition of plan confirmation. *Why Should We Have a Bankruptcy Law?*, 23 Bankr. Ct. Dec. (CRR), at A10 (Dec. 10, 1992).

81. For a discussion of out-of-court workouts, see Hon. Conrad B. Duberstein, *Out-of-Court Workouts*, 1 AM. BANKR. INST. L. REV. 347 (1993).

82. Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 345 (1990).

reorganization presents itself. When a company gets into financial difficulties, the first thought is not, "let's auction off the assets"; rather, the first thought is, "let's make a deal."

Point two concerns the means to achieve the end of maintaining the business as a going concern when voluntary arrangements cannot be effected out of court. In thinking about what those means should be, it is helpful to focus on the reasons why voluntary workouts fail. One of the biggest problems is dealing with dissenting or recalcitrant creditors.[83] Outside of some form of court-supervised model, creditors are free to pursue their own individual collection remedies—execution or garnishment by unsecured creditors, repossession and foreclosure by secured creditors, and so forth. This piecemeal seizure and sale of corporate assets has the potential to destroy the debtor's business. As Gerdes again noted, "Any system which would allow a creditor of a distressed corporation to levy upon and sell individual portions of its property would most certainly result in a vast amount of economic waste."[84] Professors Baird and Jackson, generally no fans of Chapter 11, echo that point in modern times.[85]

If some creditors are able to pursue collection in their own interest, a holdout problem appears.[86] Even if a proposed workout would be better for the entire group of creditors than a liquidation, each creditor acting selfishly has an incentive to "hold out" and not sign on to the workout agreement. The holdout creditor can threaten to pursue individual collection activities that might irreparably damage the workout unless paid in full.

Two principal remedies are needed to counter the holdout dissenter problem. One is a stay or injunction against all creditors preventing them from pursuing their own claims during the pendency of the reorganization discussions and negotiations. Such a stay preserves the status quo.[87] Under our current Bankruptcy Code section 362[88] serves this function. In equity receiverships a court-ordered injunction accomplishes the same end.

The second essential ingredient required to counter the holdout problem is the ability to bind dissenting creditors to the plan agreed to by the majority of creditors.[89] Such a provision allows the reorganization plan to

83. *See id.* at 321.

84. GERDES, *supra* note 77, § 1, at 3.

85. JACKSON, *supra* note 5, at 10-17; Baird, *World Without Bankruptcy, supra* note 5, at 183-84.

86. *See* Easterbrook, *supra* note 10, at 416-17; Gilson et al., *supra* note 82, at 321-22; Robert M. Weinstein, *Trends in Large Corporate Restructurings*, AM. BANKR. INST. J., July-Aug. 1992, at 13.

87. *See* H.R. REP. NO. 595, *supra* note 2, at 220, 340, *reprinted in* 1978 U.S.C.C.A.N. at 6180, 6296-97; JACKSON, *supra* note 5, at 151.

88. 11 U.S.C. § 362 (1988).

89. *See* H.R. REP. NO. 595, *supra* note 2, at 220, *reprinted in* 1978 U.S.C.C.A.N.

work once agreed to by the majority. Dissenters are permanently enjoined from pursuing their own prior claims after the requisite majority of creditors agree to a deal. The only claim the dissenter is left with is that provided for in the reorganization agreement itself. Once such a majority-rule provision is in effect, the incentive to hold out in the first place is largely eliminated, and meaningful negotiations can be carried out. Under our current law, section 1141 implements this policy of binding recalcitrant creditors.[90] At the same time, other provisions in Chapter 11 attempt to provide for fair treatment of the dissenters' claims.[91]

Any reform proposal that does not contain these two provisions—a stay of individual collection actions during plan negotiations and a subjugation of minority wishes to those of majority—is doomed to fail and is unworkable. Again, this is not a matter of conjecture; it is simply a recognition of the way the world works. Chapter 11 is the product of experience. Equity receiverships were used because voluntary deals could not be made. Section 77B and then Chapters X and XI, which were designed to replace equity receiverships, were enacted for the same reason. So too with Chapter 11 in 1978. Even with Chapter 11 in place, people are free to agree to out-of-court workouts, and they still do so, in large numbers.[92]

Inevitably, once a court-supervised system is in place, that colors the tenor of the negotiations that go on outside of court, prior to the initiation of court proceedings. Parties who know what their options would be in court have a baseline from which to negotiate outside of court. Recognition of that fact is not, however, a reason to decide not to have a court-supervised system in the first place. It may be a factor to consider when drafting the shape and contours of that court-supervised system, but nothing more. A

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at 6180; Gilson et al., *supra* note 82, at 321-22.

90. 11 U.S.C. § 1141(a); *see* H.R. REP. NO. 595, *supra* note 2, at 418, *reprinted in* 1978 U.S.C.C.A.N. at 6180.

91. The "best interests" test, which is codified at 11 U.S.C. § 1129(a)(7), requires a confirmed plan to provide that each holder of a claim or interest will receive at least as much under the plan as they would in a Chapter 7 liquidation. The court also must be persuaded that the plan is feasible. *Id.* § 1129(a)(11).

Classification also provides substantial protections. Only substantially similar claims or interests may be placed in the same class. *Id.* § 1122(a). Claims or interests in the same class then must receive the same treatment. *Id.* § 1123(a)(4). Unless the class is unimpaired, *id.* § 1124, class members are entitled to vote on the plan, *id.* § 1126(a), after receiving a disclosure statement that has been approved as containing "adequate information," *id.* § 1125(b). If a class does not accept the plan, then the plan proponent may only obtain confirmation under the cramdown provisions of § 1129(b). Cram down requires a showing that the plan does not discriminate unfairly, and is fair and equitable. *Id.* § 1129(b)(1). In addition, at least one impaired class must accept the plan. *Id.* § 1129(a)(10).

92. *See* Gilson et al., *supra* note 82, at 345-46.

default rule always exists. If Chapter 11 were to be repealed, the default rule then would be state collection law,[93] which carries with it the holdout problems already described. Also, state laws of execution, garnishment and the like are designed to deal only with individual collection problems, not with a collective default.[94] If one is concedes that maintenance of a going concern is preferable to piecemeal liquidation, then the need at a minimum for rules similar to current sections 362 and 1141 seems to follow.

Adopting the two provisions just referred to does not dictate any answers to the question of the extent to which a business reorganization law should reallocate or redistribute losses between different groups of creditors and equity holders. So far all I am stating is that asset value maximization, through proper deployment of the debtor's property in a going business, is to be preferred to the diminished returns available in a forced liquidation sale. At a minimum, collective action in the interests of the group as a whole should be mandated.

Some of the academic critics of Chapter 11 focus not on the utility of Chapter 11 as a potential value maximizer, but instead on the secondary effect of Chapter 11 as a mechanism for shifting losses from one group to another. This loss-shifting effect is improper, they allege. They then jump to the conclusion that Chapter 11 should be repealed, because of this reallocative tendency.[95] I fail to see the logical connection between the criticism and the conclusion. Once we have a system in place that blocks holdout activity that would be destructive to the group as a whole, losses can be apportioned in any number of ways. Several of the specific reform proposals that I will address later speak to modifications of the loss allocation. I believe that it is fundamental, however, to distinguish between proposals on the one hand that recognize the basic legitimacy of the general concept of Chapter 11 as a means for preserving value and then suggest ways to improve the efficiency of that mechanism in various particulars, and on the other hand proposals that would jettison Chapter 11 altogether. The former, I think, are fair game for discussion, on which reasonable people can disagree; the latter are, to the contrary, naive and unworkable.

III. REPEAL REJECTED

A. Overview

Let us turn briefly to address the arguments that Chapter 11 should be repealed. Two basic types of suggestions have been made to replace the court-supervised reorganization procedure we know as Chapter 11. One is

93. *See* Warren, *Bankruptcy Policy, supra* note 8, at 781-85, 808-11.

94. *Id.* at 782-85.

95. *See, e.g.,* Adler, *Risk Allocation, supra* note 5, at 489.

to let the parties handle it themselves by contract;[96] the other is to require a sale in every case.[97] Each is premised on three essential views: first, that the current scheme is inefficient—*viz.*, it takes too long, is too costly, too many cases fail, etc.; second, that Chapter 11 should not have a redistributional effect—*i.e.*, that creditor and stockholder priorities should be strictly respected; and third, that market mechanisms would work effectively. At bottom, all of the current radical proposals for repealing Chapter 11 are founded on an unswerving devotion to *laissez-faire*. Leave the parties alone, let them work it out, and all will be well.

These various free-market proposals seem to overlook one glaring point: *laissez-faire* has already been tried in this setting, and all was not well; it did not work. Businesses did fail, and workouts could not always be put together, and yet, affected parties persisted in the notion that they would be better off if the business could be reorganized. Chapter 11 is not some experiment in social engineering imposed on an unwilling business community by foolish simpletons from on high. Chapter 11, or something like it, is what the business community wanted, and still wants. Furthermore, if Chapter 11 were not necessary, then even though it is on the books it would become a dead letter.[98]

Conversely, even if Chapter 11 were repealed tomorrow, if a need for the relief afforded by that chapter persisted, replacements or surrogates for Chapter 11 would arise.[99] Perhaps equity receiverships would return to the fore. Perhaps creative Chapter 7 proceedings, with liberal interpretations of section 721[100] and substantial resort to section 105,[101] would evolve. Whatever the form, the essence would persist because, as a society, we feel it must.

B. Mandatory Auctions

Let us nevertheless consider the merits of the suggested replacements

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96. *See* Adler, *Theories, supra* note 5, at 323-33; Bradley & Rosenzweig, *supra* note 3, at 1078-88.

97. *See* JACKSON, *supra* note 5, at 218-24; Baird, *Uneasy Case, supra* note 5, at 139-45.

98. *See* Easterbrook, *supra* note 10, at 416-17 (pointing out that when auctions are superior, they will be used).

99. *See* Warren, *Untenable Case, supra* note 8, at 478.

100. 11 U.S.C. § 721 (1988) allows the court to authorize the trustee to operate the debtor's business for a limited period, if operation is in the best interest of the estate and would be consistent with the orderly liquidation of the estate.

101. 11 U.S.C. § 105(a) permits the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." Expansive uses of § 105(a) are legendary in the bankruptcy field.

for Chapter 11. One proposal is that Chapter 11 should be replaced with a mandatory auction sale under Chapter 7. Baird[102] and Jackson[103] have been the leading proponents of this view. They reason that the confirmation of a Chapter 11 plan effects a hypothetical sale of the debtor's assets to its creditors. But such a hypothetical sale creates problems of valuation and of strategic posturing in light of the valuation difficulty, they assert. Why not simply require an actual sale instead of a hypothetical sale? This allegedly would save many of the deadweight costs generated by Chapter 11 negotiations, speed up the proceedings, and provide a market solution to the valuation problem. There is no reason why the actual sale has to be piecemeal, at forced sale prices. Sell the whole business, lock, stock, and barrel as a going concern to the highest bidder. Then take the pot of cash and deal with the allocation issues.[104]

If this sounds too good to be true, it is. To begin with, a mandatory sale system was the form used in the old equity receiverships. For many reasons, that approach fell into disfavor. Going back to a forced-sale regime would require explaining why the concerns that led to the demise of the equity receivership either no longer hold true, or could be alleviated by wise implementation.

Anyway, auctions are now possible in Chapter 11 cases. The 1992 *Financial News Network*[105] case out of the Second Circuit is testament to the flexibility currently available in effecting such sales. Proponents of the mandatory auction proposal bear the burden of establishing why the benefits of making such a sale *required,* instead of *permissive,* outweigh the costs of doing so. The reasons given largely point to a distrust of non-market mechanisms;[106] a concern about Chapter 11's redistributive effects;[107] and the recognition of a prevailing ethos suggesting a disinclination to make actual sales.[108]

Each of these arguments has its own weaknesses. Furthermore, significant new problems would be created by a mandatory-auction regime. Many of the same advantages could be realized by significantly less drastic amendments to the Code. To begin with, the concerns about the efficacy of

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102. Baird, *Uneasy Case, supra* note 5, at 139-45.

103. JACKSON, *supra* note 5, at 218-24.

104. *Id.* at 209-24; Baird, *Uneasy Case, supra* note 5, at 136-47.

105. Consumer News & Bus. Channel Partnership v. Financial News Network Inc. (*In re* Financial News Network Inc.), 980 F.2d 165 (2d Cir. 1992). For a discussion of that case, see Charles J. Tabb, *Financial News Network Auction Upheld*, 13 BANKR. L. LETTER, Apr. 1993, at 3-5.

106. *See* JACKSON, *supra* note 5, at 218-21; Baird, *Uneasy Case, supra* note 5, at 136-37, 142-45.

107. *See* JACKSON, *supra* note 5, at 223.

108. *See* Baird, *Uneasy Case, supra* note 5, at 145.

non-market mechanisms and about loss shifting do not really speak to the issue of whether sales should be mandatory or permissive. The dominant reason for insisting on mandatory sales must either be a paternalistic imposition on the parties of what is best for them, whether they know it or not, or a divestiture of control from the debtor's management to prevent them from blocking a beneficial sale.[109]

The latter concern is a serious one. It is not implausible to believe that debtor management might resist a sale that would put them out of a job. This control problem, however, can be addressed without repealing Chapter 11 entirely. That is like chopping off your hand to remove a hangnail. Amending the Code to make it easier to appoint a trustee,[110] or to limit exclusivity to allow creditors to propose a sale plan,[111] or even to mandate an early inquiry into the feasibility of a sale,[112] all would limit the debtor's veto power and yet preserve the flexibility of going forward in a traditional reorganizing Chapter 11.

The detriments of a mandatory-sale system would be immense. To begin with, it is very doubtful that every Chapter 11 debtor would have a ready buyer who would value the debtor as highly as the existing creditors and stockholders—and who could be compelled to actually bid that value in a bankruptcy auction. If IBM were to file Chapter 11, is there really a competitive market of IBM buyers out there?[113] In some cases there might be, but a mandatory system would require a buyer in every case. Otherwise, the debtor would be carved up piecemeal, and the going-concern surplus would be lost.

Auction theorists have pointed out many difficulties in actually attaining full value in auction sales. There must be competition among several well-informed and well-financed bidders, a scenario that is not at all self-evident in the bankruptcy context.[114] The prospect of minimal competition is heightened when an entire industry—the airline industry, for example—is suffering from financial distress.[115]

In a typical increasing-bid auction, the bidder willing to pay the highest amount can only be forced to pay $1 over the amount the second highest bidder would pay, even if the high bidder itself placed a higher value on the property.[116] The difficulties and costs for potential bidders to obtain full

109. *See* Baird, *Revisiting Auctions, supra* note 5, at 8-13.

110. 11 U.S.C. § 1104 (1988); *see infra* part V.M.

111. 11 U.S.C. § 1121; *see infra* part V.B.

112. *See infra* part V.L.

113. *See* Aghion et al., *supra* note 5, at 8.

114. *Id.* at 7-8; LoPucki & Whitford, *Corporate Governance, supra* note 9, at 763-64; Skeel, *supra* note 10, at 477-78.

115. *See* Baird, *Revisiting Auctions, supra* note 5, at 17; Skeel, *supra* note 10, at 477.

116. *See* Bruce A. Markell, *The Case Against Breakup Fees in Bankruptcy*, 66 AM.

and accurate information about the debtor in order to make a bid would chill the bidding.[117] This problem is especially acute in the case of many insolvent firms, where ascertaining the true financial status of the firm can be difficult, if not impossible.[118] Furthermore, for all but the winning bidder, the costs of participating in the auction process will be lost, a fact which further serves to chill active bidding.[119]

Even if there were such potential buyers, the costs of locating them would be immense.[120] Perhaps the mandatory auction proposal should be relabelled the "full employment for investment bankers" proposal. While investment bankers no doubt would appreciate the new business given the easing of the takeover mania, investment bankers charge a lot for their services, and those fees would have to be paid out of the estate. Whether there would be substantial cost savings under an auction regime is far from clear.[121]

Nor is it evident that the process could be substantially speeded up, as it would take time for bidders to be located and for them to investigate the debtor. In the meantime, someone would have to run the debtor's business to preserve the going-concern surplus. The existing debtor management would have a reduced incentive to do so if they knew they were simply minding the store for an interim period before they would be thrown out on the street.

Along the same lines, it is possible that debtors would be more reluctant to file a bankruptcy petition in the first place if they knew that a sale was mandated and that they would be losing their jobs.[122] Accordingly, creditors would have to be given more extensive powers to file involuntary petitions. Whether such a development would be welcome is questionable. Creditors would have more leverage against debtors in non-bankruptcy negotiations. Other creditors also would be more at risk from the negative

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BANKR. L.J. 349, 363 (1992). For further comparison of auction theory with bankruptcy reorganization practice, see Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations,* 44 STAN. L. REV. 69, 107-11 (1991).

117. *See* Aghion et al., *supra* note 5, at 9-10; Skeel, *supra* note 10, at 478.

118. *See* Baird, *Revisiting Auctions, supra* note 5, at 19-20; LoPucki & Whitford, *Corporate Governance, supra* note 9, at 759.

119. *See* Aghion et al., *supra* note 5, at 10; Skeel, *supra* note 10, at 478.

120. *See* Easterbrook, *supra* note 10, at 415.

121. LoPucki & Whitford, *Corporate Governance, supra* note 9, at 765. Even Professor Baird, one of the spiritual fathers of the mandatory auction idea, has recognized that the costs of an auction, akin to making an initial public offering (IPO), may well exceed the direct costs of a standard Chapter 11 case with its "hypothetical" sale. Baird, *Revisiting Auctions, supra* note 5, at 9-10. He attempts to counter this point by arguing that the indirect costs of a reorganization may be much higher. *Id.* at 10-12.

122. *See* Baird, *Revisiting Auctions, supra* note 5, at 20.

effects of strategic action by some creditors in such a system.

A variant of the mandatory auction approach is to use an options system.[123] The basic idea is that all of the firm's stock would be distributed to senior creditors, and junior claimants then would be given options to purchase stock from the senior claimants by paying their pro rata share of that senior creditor's claims. In addition, the process could be opened up to outside bids for the company, as well as to bids from existing management.

While the options theory addresses some of the concerns about the pure auction approach, especially by opening up the bidding process, it too appears to be of questionable practical feasibility. Professor Skeel has thoughtfully dissected this proposal, as well as many of the others, in an article in the *Wisconsin Law Review*.[124] As Skeel points out, the essential failing of the options approach is that it depends on a perfectly efficient market, in which claimants can accurately predict the value of the firm, make informed decisions whether to exercise their option, and then have the necessary cash to actually exercise the option. Furthermore, before the options process could begin, the court must sort out the respective entitlement of the various parties, for it is necessary to know just who the senior claimants are. Once all of this becomes necessary, much of the supposed advantage over existing Chapter 11 evaporates.[125]

C. *Contingent Equity and the Preeminence of Contracts and Markets*

The foregoing sale and options proposals at least contemplate some form of court intervention while the sale or option exercise is being effected. Thus, individual creditor action would be stayed and dissenters would be bound. The proposal made by Bradley and Rosenzweig in their *Yale Law Journal* article, however, would forego any form of court supervision, except for strictly enforcing contractual default provisions agreed to by the parties ex ante.[126] Professor Adler has made a somewhat similar proposal in an article in the *Stanford Law Review*.[127]

The Bradley and Rosenzweig proposal is, in their words, a "contingent equity" scheme.[128] The reason is this: when a debt payment comes due,

123. *See* Bebchuk, *supra* note 5, at 781-88; Roe, *supra* note 5, at 559; Aghion et al., *supra* note 5, at 23-29. These proposals are critiqued by Skeel, *supra* note 10, at 479-81.

124. Skeel, *supra* note 10, at 479-81.

125. *See id.*

126. Bradley & Rosenzweig, *supra* note 3, at 1085 ("An important feature of our proposal, distinct from others, is that it *completely avoids* judicial intervention.").

127. Adler, *Theories*, *supra* note 5, at 323-33.

128. Bradley & Rosenzweig, *supra* note 3, at 1079.

the debtor must either pay it or the most junior residual equity holder class—*e.g.*, the common stock—loses all claim to the firm's assets. If the debtor is a viable entity, their theory goes, then the residual claimants should be able to raise enough money in the capital markets to meet the debt payment. If not, good riddance. Once common stock holders are eliminated, the residual interest in the firm passes up the priority ladder to the next most junior interest. That group then must decide either to pay the senior creditors or default, thereby losing their interest as well. So goes the process until the residual interest passes up to a class that pays the senior debt, or if not, to the senior creditors themselves, who thereupon "own" the firm.[129] Such a scheme would require parties to negotiate up front not only for their priority status, which later would be strictly enforced, but also for a myriad of debt covenants to block the debtor from engaging in destructive strategic behavior.[130] Overall, the beauty of the scheme, as Bradley and Rosenzweig see it, is that the market controls.[131] A long and expensive Chapter 11 is avoided.

Many commentators have assaulted the Bradley and Rosenzweig proposal, and, I believe, have exposed serious flaws.[132] The most telling criticisms are summed up neatly by Professor LoPucki's characterization of Bradley and Rosenzweig's world as a "PM-ZTC" world, *i.e.*, "perfect markets, zero transaction costs."[133] The fly in the ointment is that (1) markets do not work perfectly, and (2) transaction costs do exist. As LoPucki observes, "Bradley and Rosenzweig have . . . demonstrated again how great are the differences between the world in which we live and the world in which so many economists do their thinking."[134]

To illustrate, take one of the many critical assumptions Bradley and Rosenzweig make, namely, that a solvent but perhaps momentarily illiquid debtor facing an upcoming debt payment could resort to the debt or equity markets to raise the necessary cash to make the payment. If the debtor cannot do so, then the all-knowing market must have judged that the debtor was in fact insolvent.[135] But is that conclusion inexorable, in the real world? Does "the market" possesses the kind of information and the flexibility to react immediately and efficiently to an illiquid debtor's plea for

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129. *Id.* at 1079-85.

130. *Id.* at 1086-88.

131. *Id.* at 1085.

132. *See, e.g.*, Altman, *supra* note 10, at 10-18; Bhandari & Weiss, *supra* note 10, *passim*; Korobkin, *Unwarranted Case, supra* note 10, *passim*; LoPucki, *Strange Visions, supra* note 9, *passim;* Skeel, *supra* note 10, at 483-91; Warren, *Untenable Case, supra* note 8, *passim*; Whitman et al., *supra* note 10, *passim.*

133. LoPucki, *Strange Visions, supra* note 9, at 99.

134. *Id.*

135. Bradley & Rosenzweig, *supra* note 3, at 1081-82.

cash?[136] Note that if the market is not perfectly efficient in this context, then the Bradley and Rosenzweig proposal falls apart. Absent perfect efficiency, classes of equity or debt would be canceled even if they have a positive value, solely because of a liquidity problem.

Furthermore, Bradley and Rosenzweig assume that the residual class facing the decision to pay or default could act efficiently to make that judgment. This would require the group to have perfect information about the debtor's finances. Even more problematic, however, is the assumption that the many hundreds or even thousands of individual members of the affected class could easily coordinate and make a decision.[137] One of the reasons Chapter 11 exists is to facilitate participation and negotiation by widely dispersed constituencies. LoPucki notes that "Chapter 11 exists solely to deal with transaction costs."[138] Bradley and Rosenzweig just assume this problem away.

The scheme propounded also depends on a ready ability to define, ascertain, and enforce defaults. Extensive and costly bargaining up front would be required to regulate the many problems of possible strategic behavior by debtor management or by creditors. A fundamental difficulty exists here. Most contractual negotiations are between the debtor and a particular creditor. Other creditors are not party to those contracts; they negotiate their own deals. Yet, the problems that require resort to Chapter 11 stem largely from a need for collective action involving all creditors and equity holders. Trying to involve all parties in up-front bargaining would be every bit as difficult as bargaining in Chapter 11.

Furthermore, the emphasis on enforcing the contract highlights another critical failing of the Bradley and Rosenzweig approach. What about nonconsensual creditors?[139] Many of the most difficult Chapter 11 cases involve tort creditors, or environmental obligations, or tax claims. A pure contract-market regime does nothing in these cases.

Nor would it be a simple matter to ascertain the existence of a default.[140] Assuming along with Bradley and Rosenzweig that detailed and complex debt covenants would have to be agreed to in order to prevent various forms of strategic behavior, one might further expect that determining whether the terms of a such a complicated default provision were contravened might be difficult. Indeed, extensive litigation over the matter

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136. *See* LoPucki, *Strange Visions, supra* note 9, at 100-02; Skeel, *supra* note 10, at 483-84; Whitman et al., *supra* note 10, at 850-51.

137. *See* LoPucki, *Strange Visions, supra* note 9, at 101-03.

138. *Id.* at 106.

139. *See* Warren, *Untenable Case, supra* note 8, at 472-73.

140. *See* LoPucki, *Strange Visions, supra* note 9, at 103-04.

could be expected[141]—especially in light of the draconian ramifications of a default. One also might question the willingness of courts to give effect to the harsh scheme suggested. Would a court actually permit the vaporization of an entire equity class because of a technical default?

Another puzzle about the Bradley and Rosenzweig scheme that presents itself to real-world participants in the bankruptcy system is this: what happens *during* the process of canceling classes and moving up the priority ladder? Who runs the company, and who decides who runs the company?[142] Each time a residual class is canceled, does the next class up the ladder have the right to elect a new set of corporate directors? A company must keep operating its business if going-concern values are to be preserved. The feasibility of doing this while classes are being wiped out is unlikely. Further, absent a stay or injunction against collection action, once a default has occurred nothing would prevent creditors from enforcing their claims against the debtor company, thereby effectively mooting the "pay or default" decision.[143]

Other criticisms could be leveled against the contingent-equity scheme. In summary, however, such a system is completely unworkable in the real world, where markets are not perfect, and where transaction costs do exist. If a voluntary workout cannot be achieved, then it appears that some form of court-supervised reorganization—be it Chapter 11, or Chapter 10, or a receivership, or whatever—will be necessary to allow the efficient preservation of a going-concern surplus for all interested parties. Let us now turn to a detailed consideration of various suggestions for improving the operation of the current reorganization scheme.

IV. TWO CHAPTERS OR ONE—IS CHAPTER 10 A DESIRABLE ADDITION?

One of the most hotly debated proposals is to add a new small-business chapter to the Bankruptcy Code. Both S. 1985, passed in 1992 by the Senate,[144] and S. 540,[145] the currently pending bill, provide for such a chapter on a pilot district basis. The experiment is called Chapter 10. Adoption of Chapter 10 would signal a return to the two-chapter business reorganization system used under the Act (but of course, in the interest of confusion, with the numbers of the large- and small-business chapters reversed). In weighing the wisdom of this idea, it might be useful to harken

141. *See* Whitman et al., *supra* note 10, at 855-56.

142. *See* Lopucki, *Strange Visions, supra* note 9, at 104-05; Skeel, *supra* note 10, at 486.

143. *See* Rosen, *supra* note 14, at 47.

144. S. 1985, *Passed Version, supra* note 57, § 205.

145. S. 540, *Reported Version, supra* note 64, § 201.

back to the reasons why the reformers of the 1970s decided to junk the two-chapter approach, and ask whether those reasons still obtain.

One of the primary criticisms in the 1970s of the multiple-chapter approach to reorganizations was the difficulty of sorting out which debtors should be allowed to proceed under which chapter.[146] The Act did not use a per se rule to distinguish between proper debtors; instead, the propriety of relief depended on the "needs to be served" by the filing.[147] One ramification of this uncertainty was extensive litigation over the chapter choice.[148] A second and related problem was that over time, the use of one chapter, Chapter XI, came to predominate.[149] Most debtors preferred Chapter XI because they wanted to retain control over the case, with permanent exclusivity in plan filing and freedom from the restrictions of Chapter X, such as the mandatory appointment of a trustee and the powerful supervisory role of the SEC.[150]

One way to solve this sorting problem is to impose an arbitrary cutoff. Examples of yardsticks that could be used include the amount of debt, or total assets, or the number of public security holders, and the like. This tack would have the major benefit of reducing litigation over chapter selection. The version of Chapter 10 favored by the Senate takes this bright-line approach. It defines a "small business" as one with $2.5 million or less in liquidated debts.[151] An earlier version of the 1992 bill would have opted for an open-ended, multi-factor test gauged ultimately by whether the "best interests" of the estate would be served by proceeding in Chapter 10.[152]

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146. *See* H.R. REP. NO. 595, *supra* note 2, at 221-24, *reprinted in* 1978 U.S.C.C.A.N. at 6181-83; COMMISSION REPORT, *supra* note 74, pt. 1, at 245-48.

147. General Stores Corp. v. Schlensky, 350 U.S. 462 (1956).

148. *See* H.R. REP. NO. 595, *supra* note 2, at 223, *reprinted in* 1978 U.S.C.C.A.N. at 6182; COMMISSION REPORT, *supra* note 74, pt. 1, at 247.

149. *See* 124 CONG. REC. H11,102 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,418-19 (daily ed. Oct. 6, 1978); H.R. REP. NO. 595, *supra* note 2, at 222, *reprinted in* 1978 U.S.C.C.A.N. at 6182 (less than 10% of business reorganization cases under Chapter X); COMMISSION REPORT, *supra* note 74, pt. 1, at 246-47.

150. *See* H.R. REP. NO. 595, *supra* note 2, at 222, *reprinted in* 1978 U.S.C.C.A.N. at 6182; COMMISSION REPORT, *supra* note 74, pt. 1, at 247.

151. S. 540, *Reported Version*, *supra* note 64, § 201(a).

152. S. 1985, § 205(a)(2), 102d Cong., 1st Sess. (1991), *reprinted in* 137 CONG. REC. S17,049 (daily ed. Nov. 19, 1991) [hereinafter S. 1985, *Introduced Version*]:

> "small business" means a person engaged in commercial and business activities where, if appropriate, after court determination, it is found that the best interests of an estate will be served by having such person deemed to be a small business, in light of—
>
> (A) the number of employees of the person's business activity;
>
> (B) the number of creditors of the person's business activity;
>
> (C) the number of secured, priority, and unsecured creditors of the

Professor Skeel has suggested a different eligibility standard, focusing on whether the debtor is a close corporation or not.[153]

As is true with all arbitrary cutoffs, a bright-line approach to the eligibility issue has the problem of being arbitrary. It would be both underinclusive and overinclusive. Devising an easily applied objective standard that would put only the "right" debtors into one chapter would be well-nigh impossible. The reformers of the 1970s found this to be an insuperable problem.[154] Is the situation any different now? The answer is probably not. It is likely that some debtors with only $2.4 million in debt might have complicated problems suggesting that Chapter 11 is a preferable forum, while a simple, closely held business with $2.6 million in debts might be the paradigmatic Chapter 10 candidate. Ultimately the question is whether we can live with this rough justice, comparing the burdens and benefits. Perhaps we can; exactness in chapter choice may not be that important a value. I would agree with the Senate reformers that if a separate small-business chapter is deemed worth the trouble, then it is essential to have a bright-line eligibility rule. Otherwise, litigation over eligibility will overwhelm any advantages that otherwise might accrue.

The impetus behind the Chapter 10 movement comes mostly from a desire to reduce the length and cost of reorganization cases involving small businesses.[155] The procedures and mechanisms spelled out in Chapter 11 are thought to be unnecessary overkill in many smaller cases. Examples include the requirement that a creditors' committee be appointed in every

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person's business activity;

(D) the value of the assets of the person's business activity;

(E) the dollar volume of sales of the person's business activity;

(F) the nature and substance of the person's business activity;

(G) the history of the person's business activity;

(H) the nature and substance of the person's business activity as measured by similar persons engaged in the same business activity; and

(I) other pertinent factors.

Senator Grassley described this as a "totality of the circumstances" test. 137 CONG. REC. S17,057 (daily ed. Nov. 19, 1991) (remarks of Sen. Grassley).

153. Skeel, *supra* note 10, at 510-17.

154. *See* H.R. REP. NO. 595, *supra* note 2, at 223, *reprinted in* 1978 U.S.C.C.A.N. at 6182 ("In sum, any justification that existed in 1938 for two reorganization chapters has disappeared."); COMMISSION REPORT, *supra* note 74, pt. 1, at 248 ("[I]t is not feasible to carve out of Chapter XI certain cases which should be under Chapter X. . . . Suggestions for an arbitrary cutoff are without merit. The only solution is an elimination of the disparate procedures.").

155. S. REP. NO. 168, *supra* note 64, at 39, 43; *see also* Hon. John C. Akard, *Chapter 13 for Small Business?*, AM. BANKR. INST. J., Sept. 1992, at 17; Thomas E. Ray, *Chapter 13—A Little Surgery Could Go a Long Way*, AM. BANKR. INST. J., Mar. 1993, at 31.

case,[156] that the court approve a disclosure statement that will be mailed to everyone,[157] and that presumptively all creditors and equity holders must vote on the plan.[158]

What sorts of changes would Chapter 10 make in the interests of expedition and economy? Section 1021 would compel the debtor to file a plan within ninety days after the order for relief.[159] Extensions could be granted only if "substantially justified,"[160] a standard apparently intended to be more demanding than the current "cause" standard in section 1121.[161] The debtor retains throughout the exclusive right to file a plan. Confirmation under section 1026 would not require a vote of creditors.[162] This in turn would obviate the need for a general disclosure statement.[163] The hearing on confirmation must be concluded not later than forty-five days after the plan is filed, with an exception for cause.[164]

No provision is made for the appointment of committees; given the absence of a creditor vote and unlimited debtor exclusivity, the need for negotiations largely disappears. The monitoring function of Chapter 11 committees would be performed by a standing trustee analogous to a Chapter 13 trustee.[165] Placing the monitoring in the hands of a standing trustee supposedly would counter the widespread problem of creditor apathy in small cases.[166]

Another significant change from Chapter 11 practice that Chapter 10 would countenance is the abrogation of the absolute priority rule. Under

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156. 11 U.S.C. § 1102(a)(1) (1988).

157. *Id.* § 1125(b).

158. *Id.* § 1126(a).

159. S. 540, *Reported Version, supra* note 64, § 201(c) (to be codified at 11 U.S.C. § 1021).

160. *Id.*

161. 11 U.S.C. § 1121(d).

162. S. 540, *Reported Version, supra* note 64, § 201(c) (to be codified at 11 U.S.C. § 1026). The accompanying report states that the provisions of Chapter 10 "do not provide creditors with ultimate veto authority to prohibit the plan from being confirmed." S. REP. NO. 168, *supra* note 64, at 45.

163. Somewhat mystifyingly, however, proposed § 1023 would require a disclosure statement to be sent before soliciting acceptances or rejections of the plan. S. 540, *Reported Version, supra* note 801, § 201(c) (to be codified at 11 U.S.C. § 1023). As noted in the text, however, voting is eliminated from the Chapter 10 process. Anyway, all that § 1023 would require is a disclosure statement that "includes information sufficient to show whether or not the plan meets the requirements of section 1026." *Id.* Furthermore, that section would allow for a standard form disclosure statement as approved by the court. *Id.*

164. *Id.* § 201(c) (to be codified at 11 U.S.C. § 1025(d)).

165. S. REP. NO. 168, *supra* note 64, at 43.

166. *Id.*

section 1026 the equity holders could retain an interest and confirm a plan over the objection of creditors if (1) the best interests test is met,[167] and (2) the debtor commits all disposable income over a three-year period to plan payments.[168] Allowing current owners to stay in place is consistent with the prevailing notion that in small companies, unlike large public companies, much of the value of the business is inextricably tied up in the personalities of specific individual managers.

Many of these changes seem to make substantial sense for small business debtors. But, perhaps the essential benefits of these modifications can be realized within the confines of existing Chapter 11, without the necessity for creation of a separate chapter. In other words, would it not be better if Chapter 11 could be drafted so as to be flexible enough to accommodate large corporations as well as Mom-and-Pop grocery stores? Those responsible for creating Chapter 11 in the 1978 Code thought the answer was "yes";[169] after a decade and a half of experience, the answer appears to be both "yes" and "no."[170]

Certainly parts of Chapter 11 as it now exists grant the court substantial flexibility. The exclusivity provision, section 1121, is an example. A court can shorten or extend the period for cause.[171] In practice, however, reductions in exclusivity almost never occur, whereas extensions are often routine. The merits of proposed changes to section 1121 designed to counter this exercise of judicial discretion will be discussed below. But is it necessary to create a separate chapter to deal with this problem? If a court wants to extend exclusivity, it can just as well make a finding that the extension is "substantially justified" in Chapter 10 as it could find that "cause" is shown in Chapter 11. And, even if the belief is that a different express standard is needed to discipline judges, that change could be accomplished within section 1121 itself. Section 1121 could be amended to

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167. S. 540, *Reported Version*, *supra* note 64, § 201(c) (to be codified at 11 U.S.C. § 1026(a)(4)).

168. *Id.* (to be codified at 11 U.S.C. § 1026(b)(2)).

169. *See* 124 CONG. REC. H11,102 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,419 (daily ed. Oct. 6, 1978); H.R. REP. NO. 595, *supra* note 2, at 223-24, *reprinted in* 1978 U.S.C.C.A.N. at 6183 ("The bill adopts a consolidated chapter for all business reorganizations. . . . It adopts much of the flexibility of Chapter XI of current law, and incorporates the essence of the public protection features of current Chapter X.").

170. In introducing S. 1985 in the 102d Congress, Senator Heflin stated: "The current code is required to handle both the corporate reorganizations of a multibillion-dollar international company and that of the small, rural grocery store. Trying to make the same set of laws apply to vastly different corporate enterprises has created problems and inefficiencies in the handling of individual bankruptcy cases." 137 CONG. REC. S17,047 (daily ed. Nov. 19, 1991) (remarks of Sen. Heflin).

171. 11 U.S.C. § 1121(d) (1988).

provide that extensions for debtors with $2.5 million or less in debts may only be granted if "substantially justified". This aspect of Chapter 10 does not in any respect appear to dictate an entirely separate chapter.

Other of the changes included in proposed Chapter 10 could likewise be accomplished by amendment of Chapter 11, or simply by judicial interpretation of existing provisions. Many of the innovations effected by Judge Small in North Carolina suggest the potential of this approach.[172] Appointment of creditors' committees could be made optional, reflecting actual practice in many small cases. The disclosure statement standards in section 1125 are very open-ended, and minimal disclosure could be allowed. Time savings could be realized by folding the disclosure statement approval hearing into the confirmation hearing. Strict time standards for all hearings could be set by the court.

Other changes do go substantially beyond current Chapter 11. Most notable are the complete disenfranchisement of creditors and equity holders, permanent exclusivity for the debtor, and the accompanying abrogation of the absolute priority rule. If these changes are deemed desirable, then there really is no point to trying to bend Chapter 11 around to fit. A separate chapter would be the way to go. I would note, however, that it might be easier in this event simply to amend Chapter 13 by expanding the pool of eligible debtors to include corporations and partnerships and raising the debt ceiling than to enact a whole separate small-business chapter that essentially copies Chapter 13.[173]

On the merits of these proposals of disenfranchisement, permanent exclusivity, and elimination of absolute priority, reasonable people again can differ. My own personal bias is against the proposed changes. I think they would vest too much power in the hands of the debtor and would allow the debtor to capture almost all of the going-concern surplus.[174] The supposed protection that all disposable income must be committed to the plan for three

172. Indeed, Judge Small's program inspired the drafting of Chapter 10. *See* 137 CONG. REC. S17,057 (daily ed. Nov. 19, 1991) (remarks of Sen. Grassley). For a description of the program, see Hon. A. Thomas Small, *Small Business Bankruptcy Cases*, 1 AM. BANKR. INST. L. REV. 305 (1993); *see also* Greenwald, *supra* note 16, at 61.

173. This suggestion has also been made by Akard, *supra* note 155, at 17; Ray, *supra* note 155, at 35.

174. In this respect, I tend to agree with Senator Hatch, who filed "Additional Views" on S. REP. NO. 168, *supra* note 64, at 60 ("[I]n my opinion, it is ill advised to deprive unsecured creditors of the power to vote and to capture the going concern value of the business."). Also, the National Bankruptcy Conference opposes Chapter 10, objecting in particular to the lack of a creditor vote and the grant of permanent exclusivity to the debtor. Detailed Statement of Position of the National Bankruptcy Conference on S. 540, *reprinted in* S. REP. NO. 168, *supra* note 64, at 62.

years[175] is, I believe, largely illusory. In the context of a business, I suspect courts will have an extraordinarily hard time defining "disposable income," and that doubts will be resolved in favor of the debtor. The definition of disposable income in section 1001 is necessarily vague.[176] Indeed, the concept really does not even make sense in the context of a business. What is "necessary for the continuation, preservation, and operation of the debtor's business" depends on the business philosophy of the debtor. For example, there is no single right answer as to how much should be paid in dividends as opposed to how much should be reinvested in the business.

For these reasons, I would oppose a separate Chapter 10. If, however, the policy decision is made that for most small businesses the going-concern surplus should be allocated almost entirely to existing owners because of the person-specific values generated by those owners, then some form of separate chapter makes sense. I do not think notions of cost and time should control the decision, however, because similar savings can be realized within the confines of existing Chapter 11. Having said that, it seems that the primary stated motivation behind the Chapter 10 movement is to save time and money.[177] If that is true, then I would strongly urge revising Chapter 11 practice, not creating a whole new chapter.

I have not spoken to the constitutional problem that might be created if Chapter 10 is adopted on a pilot district basis, as S. 540 proposes.[178] I have focused rather on the merits of Chapter 10. The constitutional issue is whether adoption in only eight judicial districts would violate the uniformity requirement in the Bankruptcy Clause.[179] Many believe that there is a substantial chance that it would.[180] I agree. The defense urged is that only "geographical" uniformity is required; however, it is hard to see how even that test would be met in this instance. Unlike the pilot program for United States Trustees, which dealt only with the mechanics of bankruptcy

175. S. 540, *Reported Version*, *supra* note 64, § 201(c) (to be codified at 11 U.S.C. § 1026(b)(2)).

176. S. 540, *Reported Version*, *supra* note 64, § 201(c) (to be codified at 11 U.S.C. § 1001) defines "disposable income" as "income that is received by a debtor and that is not reasonably necessary to be expended for payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business."

177. S. REP. NO. 168, *supra* note 64, at 39.

178. S. 540, *Reported Version*, *supra* note 64, § 201(e).

179. U.S. CONST. art. I, § 8, cl. 4 gives Congress the power to enact "uniform laws on the subject of bankruptcies."

180. Senator Hatch raised this question in his "Additional Views" to S. REP. NO. 168, *supra* note 64, at 60; *see also* Detailed Statement of Position of the National Bankruptcy Conference on S. 540, *reprinted in* S. REP. NO. 168, *supra* note 64, at 61-62; ABI LEGIS. BULL. (Am. Bankr. Inst., Washington, D.C.), Sept. 20, 1993.

administration, Chapter 10 would affect the substantive rights of the parties. The pending Chapter 10 proposal bears a much closer resemblance to the legislation that was struck down by the Supreme Court in *Railway Labor Executives' Ass'n v. Gibbons*.[181] If Congress feels compelled to give Chapter 10 a trial, I would urge nationwide adoption to obviate the constitutional problem.

V. CHAPTER 11 REFORM PROPOSALS

A. *Overview*

One of the predominant criticisms of Chapter 11 is that it takes too long. Studies have shown an increase in the average time spent in Chapter 11, in the range of one-and-a-half to two-and-a-half years.[182] The sense is that operating in Chapter 11 has become an end in itself, rather than simply a temporary way station en route to the end of a confirmed plan and a restructured business.

As might be expected, the concern that Chapter 11 cases are taking too long leads naturally to the charge that Chapter 11 cases cost too much. Undoubtedly the best way to cut the cost of Chapter 11 cases is to reduce the time debtors spend in Chapter 11.[183] In addition, other direct ways of cutting costs may exist.

Many factors contribute to the time and cost problem, and I will address a number of possible remedies. Commonly cited culprits include:

(1) Debtor retention of exclusivity.[184] The concern is that debtors who retain exclusivity can present a reorganization plan favorable to their own interests on a take-it-or-leave-it basis, and essentially wait out the creditors, who eventually will be forced either to risk a liquidation by calling the debtor's bluff or to accede to the debtor's plan.

(2) Lack of an "absolute" absolute priority rule.[185] Tied in with the exclusivity problem is the fact that even for an insolvent company, creditors can agree to give up value to equity interests. This may prompt otherwise out-of-the-money constituencies to play a hold-up game by stalling the case until creditors let equity have a slice of the pie.

(3) "Too many cooks spoil the broth."[186] To use another metaphor, too many players are sitting at the negotiating table, with their ante being paid by the bankruptcy estate. This makes bargaining more complex and

181. 455 U.S. 457 (1982).

182. *See* Altman, *supra* note 10, at 3-4; LoPucki, *supra* note 12, at 739-45.

183. *See* LoPucki, *supra* note 12, at 730-31.

184. S. REP. NO. 168, *supra* note 64, at 40; *see infra* part V.B.

185. *See infra* part V.J.

186. *See infra* part V.H.

reduces the incentive for these groups to agree to a deal.

(4) Professional fees are too high.[187] Related to the prior problem is the fact that many lawyers are receiving very large fees from the bankruptcy estate, especially in big cases. These professionals supposedly have little incentive to bring the case to a quick conclusion and thereby kill their golden goose.

(5) Safe haven for managers. Some claim that the debtor's management finds Chapter 11 a safe place to hold on to their jobs in the face of hostile creditor groups. They thus have little incentive to exit from Chapter 11 and put their jobs back on the line. This criticism sounds damning, but in fact is largely erroneous. Studies have shown that most debtor managers lose their jobs. If they are seeking a safe haven in Chapter 11, the evidence suggests that they are uninformed.[188]

(6) Time is *not* money.[189] Interest does not have to be paid in Chapter 11.[190] Debtors thus have a competitive advantage simply because they are in Chapter 11, an advantage they may be loathe to relinquish.

(7) Soft judges. Finally, the allegation is made that bankruptcy judges are too lenient to debtors and are too unwilling to pull the plug on hopeless cases.

Many of these problems do exist. Happily, it might be possible to deal with many of them at least in part by providential amendment of the Bankruptcy Code. At the same time, Congress can only do so much. At some point bankruptcy judges and bankruptcy lawyers must change their attitudes. Judges have to get serious about keeping Chapter 11 cases going and writing them off when realistic hope is gone. Lawyers need to counsel against throwing hopeless debtors into Chapter 11. The innovative program installed by Judge Small is indicative of what an aggressive judge can do within the confines of the existing Code.[191] Many other examples illustrate, to the contrary, that recalcitrant judges can frustrate congressional attempts to require expedition.

One "speed" and "cost" saving proposal, of course, is to enact a separate small business chapter, such as Chapter 10, which I just discussed.[192] This would hurry the case by imposing stricter deadlines for filing a plan and for conducting a confirmation hearing, and by eliminating

187. *See infra* part V.I.

188. *See infra* note 378 and accompanying text.

189. *See infra* part V.G.

190. 11 U.S.C. § 502(b)(2) (1988) (disallowing claims for unmatured interest at the time of the bankruptcy filing); *cf. id.* § 506(b) (allowing postpetition interest to the extent a claim is oversecured).

191. *See supra* note 172 and accompanying text.

192. *See supra* Part IV.

or restricting some of the current steps in the Chapter 11 process, such as the disclosure statement hearing[193] and the solicitation of the vote.[194] As I stated in my discussion of Chapter 10, however, it seems that most of these proposals could be implemented in the context of Chapter 11 itself, while those that could not are premised more on distributional determinations than on savings of time and money.

So, let me now turn to a consideration of some of these other proposals. These include:

(1) limit the debtor's retention of the exclusive right to file a plan;[195]
(2) expand the powers of the bankruptcy judge to speed up the case;[196]
(3) make stay relief determinations more expeditious;[197]
(4) require a threshold finding of feasibility, either at the outset of the case or at some early juncture;[198]
(5) require debtors to pay interest during the pendency of the case;[199]
(6) reduce the number of committees, and reduce the fees paid to these committees;[200]
(7) reduce professional fees;[201]
(8) tighten up the absolute priority rule and the so-called "new value exception";[202]
(9) make pre-packaged plans easier to confirm;[203] and
(10) facilitate major asset sales.[204]

After I discuss these suggestions, I will focus on a final suggested reform, namely to appoint a trustee or an examiner in every case.[205] This proposal would in theory address several of the criticisms of Chapter 11.

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193. 11 U.S.C. § 1125(b); FED. R. BANKR. P. 3017(a).

194. 11 U.S.C. § 1125(b), (c); FED. R. BANKR. P. 3017(d).

195. S. 540, *Reported Version*, *supra* note 64, § 102 (to be codified at 11 U.S.C. § 1121(d)); *see infra* part V.B.

196. S. 540, *Reported Version*, *supra* note 64, § 105 (to be codified at 11 U.S.C. § 105(d)); *see infra* part V.C.

197. S. 540, *Reported Version*, *supra* note 64, § 101 (to be codified at 11 U.S.C. § 362(e)); *see infra* part V.D.

198. *See infra* part V.F.

199. *See infra* part V.G.

200. *See infra* part V.H.

201. S. 540, *Reported Version*, *supra* note 64, § 309 (to be codified at 11 U.S.C. § 330(a)); *see infra* part V.I.

202. *See infra* part V.J.

203. *See infra* part V.K.

204. *See infra* part V.L.

205. *See infra* part V.M.

B. Limit Debtor's Exclusivity

Perhaps the reform suggestion most commonly raised is to limit the debtor's exclusive right to file a reorganization plan.[206] The perception is that the norm in Chapter 11 practice today is for debtors to retain exclusivity for the duration of the case. Notwithstanding the apparent dictate of section 1121 that 120 days should be the normal exclusive period,[207] courts routinely extend exclusivity, sometimes for years.[208] But Congress did not want to give the debtor unlimited exclusivity, because, in the words of the 1977 House Report, "Creditors are excluded. The exclusive right gives the debtor undue bargaining leverage, because by delay he can force a settlement out of otherwise unwilling creditors . . . ."[209]

With exclusivity in place, the argument goes, cases last longer, as each side tries to wait out the other. This delay, in turn, drives up the cost of the proceedings. This characterization of the nexus between exclusivity and delay is not universally accepted, of course. The National Bankruptcy Conference takes the view that criticism of exclusivity as a "culprit in delay . . . is ill informed and false,"[210] arguing instead that "the real cause [of delay] is the failure of constituencies to arrive at common ground through negotiation."[211]

This whole problem is a fascinating case study in the relationship between Congress and the courts. In reviewing not only the literal terms of the Code but the legislative history as well, it appears that Congress intended for 120 days to be the standard practice and did not expect or want routine extensions to occur.[212] The courts, however, have largely frustrat-

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206. *See, e.g.,* Altman, *supra* note 10, at 4; LoPucki & Whitford, *Venue Choice, supra* note 9, at 48; LoPucki & Whitford, *Corporate Governance, supra* note 9, at 788; Whitman, *supra* note 10, at 860; Greenwald, *supra* note 16, at 61; Passell, *supra* note 16, at C9; Wechsler, *Money to Burn?, supra* note 16, at 72.

207. 11 U.S.C. § 1121(b), (c)(2), (d) (1988).

208. *See* Altman, *supra* note 10, at 4; LoPucki, *supra* note 12, at 753; *see also* Richard M. Cieri et al., *Applying an Ax when a Scalpel Will Do: The Role of Exclusivity in Chapter 11 Reform*, 2 J. BANKR. L. & PRAC. 397, 410 (1993).

209. *See* H.R. REP. NO. 595, *supra* note 2, at 231, *reprinted in* 1978 U.S.C.C.A.N. at 6191.

210. *The Bankruptcy Improvements Act of 1993: Hearings on S. 540 Before the Subcomm. on Courts and Admin. Practice of the Sen. Comm. on the Judiciary, Statement of Position of the National Bankruptcy Conference on S. 540*, 103d Cong., 1st Sess. 10 (1993) [hereinafter *Statement of Position of NBC on S. 540*].

211. *Id.* at 11.

212. *See* H.R. REP. NO. 595, *supra* note 2, at 232, *reprinted in* 1978 U.S.C.C.A.N. at 6191 ("In most cases, 120 days will give the debtor adequate time to negotiate a settlement, without unduly delaying creditors.").

ed the congressional intent. What is to be done? The choices effectively boil down to two: (1) Congress can still leave the courts some flexibility to deal with the mega-cases—a Manville is not going to settle quickly no matter what—but at the same time can tell the courts "we really mean it" that extensions are to be the exception and not the rule; or, (2) the courts can have all of their discretion stripped away, and an absolute time bar can be implemented. In any event, a remarkable consensus exists that something must be done.[213]

Proposed legislation in the 102d[214] and 103d Congress has followed the "we really mean it" school of thought. Section 102 of S. 540 would add a provision to section 1121(d) placing an almost absolute one-year limit on debtor exclusivity for filing.[215] The "almost" is that Congress left an out; the one-year limit would apply "unless the need for such an increase is attributable to circumstances for which the debtor should not justly be held accountable."[216] That, of course, opens up a whole can of worms as to when the debtor should or should not "justly be held accountable." If the debtor and the creditors are at loggerheads and neither will give in to the other, is that a circumstance for which the debtor should or should not justly be held accountable? The answer to that question will dictate in part the bargaining position that the respective groups can take.

Despite the obvious intent of Congress to make extensions of exclusivity beyond one year harder to come by,[217] in actuality it is possible that the proposed new standard would not have any significant effect at all. Under current law it is hard to imagine that a court would find "cause" to grant an extension of the debtor's exclusive right[218] if the court were persuaded that the need for an extension was driven by circumstances for which the debtor should "justly be held accountable." The proposed amendment might have an effect, however, if it serves to catch the attention of bankruptcy judges and wake them up to the real intention of Congress. My suspicion, however,

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213. *See, e.g.,* Altman, *supra* note 10, at 4; Cieri et al., *supra* note 208, at 422; LoPucki, *supra* note 12, at 756; Whitman, *supra* note 10, at 859-60.

214. S. 1985, *Final Version, supra* note 63, § 102 (to be codified at 11 U.S.C. § 1121(d)).

215. S. 540, *Reported Version, supra* note 64, § 102 (to be codified at 11 U.S.C. § 1121(d)).

216. *Id.* (to be codified at 11 U.S.C. § 1121(d)(2)).

217. S. REP. NO. 168, *supra* note 64, at 40 explains that "[o]ften, these extensions lead to unnecessary and expensive delay in the pendency of the chapter 11 case." In connection with the 1992 legislation, Representative Fish observed that "we seek to discourage long postponements for filing proposed reorganization plans—in recognition of the potential harm that can result from delay." 138 CONG. REC. H11,057 (daily ed. Oct. 3, 1992) (remarks of Rep. Fish).

218. 11 U.S.C. § 1121(d) (1988).

is that judges already know very well what Congress intended; they just think they know better. Some concern has been expressed that the proposed new standard would place unwarranted restraints on the discretion of bankruptcy judges in deciding whether to extend exclusivity.[219] The debate, I suppose, is over what restraints are warranted; many feel that current law falls short of the proper mark and that the proposed change would be beneficial.[220]

The question then is whether the other approach, an absolute limit on exclusivity with no exceptions at all, would be preferable either to current law or to the pending proposal. The most obvious criticism of an absolutist approach is, of course, that it would be totally inflexible.[221] Some cases by their size and complexity simply cannot be resolved in a relatively short period of time, such as a year. All of the studies show an average time in Chapter 11 for large, publicly held companies in excess of a year.[222] Yet, the answer cannot be to extend the absolute time limit to account for the longest expected case, for that then would eviscerate the meaningfulness of the limitation for the great bulk of cases that could be concluded in a shorter time period.

Here is a situation where two different rules for large and small companies might be merited. The LoPucki and Whitford study also showed that most of the large cases were successful, in that a plan was confirmed.[223] This success ratio departs rather dramatically from the very weak performance of smaller cases.[224] In short, the time appears well-spent in a large case, but not in smaller cases. One possible solution then might be to impose an absolute cap on exclusivity for small, non-public companies, but not to impose one for large, publicly held companies.

If one accepts that any absolute exclusivity limit, to be meaningful and useful, must cut off a certain percentage of cases, the question then becomes what happens in those cases in which exclusivity does expire. By definition, of course, what it means is that any party in interest can file a plan. What then happens to the bargaining dynamic? When exclusivity terminates, does everybody quit talking to each other and negotiating, and go off and file their own plan?[225] Or, do the creditors continue to talk to the debtor and

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219. *See* ABI LEGIS. BULL. (Am. Bankr. Inst., Washington, D.C.), Sept. 20, 1993.

220. *See, e.g.*, CLEVELAND BAR ASS'N, REPORT ON SENATE BILL 540: BANKRUPTCY AMENDMENTS OF 1993 (1993) [hereinafter CLEVELAND BAR ASS'N REPORT].

221. *See* Cieri et al., *supra* note 208, at 422-23; Rosen, *supra* note 14, at 48.

222. *See* LoPucki, *supra* note 12, at 739-45 (discussing the results of various studies).

223. LoPucki & Whitford, *Patterns, supra* note 9, at 600-01.

224. *See* Flynn, *supra* note 49, at 13.

225. This is the scenario the National Bankruptcy Conference paints in opposing any changes to the current exclusivity rules. In *Statement of Position of NBC on S. 540, supra* note 210, at 11, the NBC argues: "[B]y extending exclusivity for the debtor, the

each other, with the only important consequence being that the debtor has lost a bargaining chip?

The truth probably lies somewhere in between those extremes. In a sense, it is difficult to make a knowledgeable prediction as to what would happen, because there is so little experience under the Code in cases where the debtor did lose exclusivity. The experience under Chapter X of the Act probably cannot be imported very helpfully to inform the discussion, because the whole scheme there was so different, with a mandatory trustee and the active participation of the SEC in every case.[226]

It does seem that imposition of an absolute exclusivity limit would favor creditors relatively as opposed to debtors and equity. Creditors would know that at some known point in the future they would be able to put forward their own plan, and to cram it down over the objections of the debtor. This knowledge undoubtedly would color the preceding negotiations and could lead to a more favorable allocation of reorganization value to creditor interests. It is doubtful that equity holders would be cut out entirely on a routine basis, because an elimination of equity interests would require a full valuation of the company under the fair and equitable cramdown test. Creditors are believed to be averse to such a valuation.

I think that, in at least some cases, the presence of an exclusivity limitation would likely decrease the length of the proceedings. The debtor would know that holding out forever would not work, and thus it might as well cut a deal with creditors sooner rather than later. Indeed, debtors may be able to trade time for money directly with the creditors. In effect, the debtor could say to the creditors, "you will have to wait a year for exclusivity to expire, and I could stall you until then. If you will give equity a little bigger piece of the pie, however, I will file a plan in four months. You thus save eight months—a fair trade for a little bonus for equity."

At the same time, the foregoing hypothetical suggests that imposing an absolute one-year time limit may have the unintended effect of actually increasing the time in some cases. I think that it is not unrealistic to project that judges under such a system would be even more inclined almost always to give the debtor a year to work things out. In many of the smaller cases it is doubtful whether that much time is needed.

Proponents of an absolute exclusivity limit also must admit that in some

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judge keeps all parties talking together. When exclusivity is lifted, the danger arises that each constituency, usually at great expense to the debtor, will run up time drafting its own plan. This produces a Tower-of-Babel turf fight that is nearly impossible to resolve."

226. For brief summaries of Chapter X practice, see 124 CONG. REC. H11,101 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,417 (daily ed. Oct. 6, 1978); H.R. REP. NO. 595, *supra* note 2, at 221-23, *reprinted in* 1978 U.S.C.C.A.N. at 6181-83; COMMISSION REPORT, *supra* note 74, pt. 1, at 241-45.

cases the bargaining dynamic will fall apart once exclusivity terminates, or is about to terminate. Giving creditors more leverage inevitably will lead to occasional abuses of that leverage. The questions are how often this will occur and whether the costs exceed the benefits projected from adopting exclusivity. Absent a crystal ball, I find it hard to make that judgment. At bottom, I find it sad that bankruptcy judges cannot be entrusted with the discretion to make the right call on a case-by-case basis. Part of me wants to give the judges one more chance.

C. Expand Powers of Judges

Perhaps that chance could come in part in the form of an amendment to section 105, such as that proposed in S. 540.[227] As originally envisioned in S. 1985, in lieu of imposing a cap on exclusivity, the amendment would have added a new section 1121(e), authorizing the bankruptcy judge to hold a status conference and to issue orders "to ensure that the case is handled expeditiously and economically."[228] Examples of the types of orders that might be entered are to set a date to file a disclosure statement; to set a date for confirmation; to set a date for other parties to file a plan; and to provide for folding the disclosure statement hearing into the confirmation hearing. These provisions track very neatly the procedures set up by Judge Small in his highly regarded "fast-track" Chapter 11(a) system.[229] The final version of the conference bill to S. 1985 placed this provision in a new section 105(d),[230] as does current S. 540.[231] Without detailing the types of orders that might be entered, this amendment would empower the bankruptcy judge to hold a status conference and to issue orders that, again, would help "ensure that the case is handled expeditiously and economically."[232]

In one sense the proposed amendment to section 105 is probably unnecessary, as bankruptcy judges already possess the power to hold status conferences and issue the types of orders described in the proposed subsection.[233] It may be, however, that absent express language to that

227. S. 540, *Reported Version*, *supra* note 64, § 105 (to be codified at 11 U.S.C. § 105(d)).

228. S. 1985, *Passed Version*, *supra* note 57, § 209 (to be codified at 11 U.S.C. § 1121(e)).

229. *See supra* note 172 and accompanying text.

230. S. 1985, *Final Version*, *supra* note 63, § 105 (to be codified at 11 U.S.C. § 105(d)).

231. S. 540, *Reported Version*, *supra* note 64, § 105 (to be codified at 11 U.S.C. § 105(d)).

232. *Id.*

233. For a good discussion of what judges currently can do and are doing, see Hon.

effect, some judges may be reticent to take such aggressive case management steps. If adding a new section 105(d) might encourage some judges to move forward in this respect, then it might be worthwhile.

Harking back to the discussion in the last section, my own preference is that an absolute cap on exclusivity should be deferred for now in favor of trying the status conference approach. The rigidity of an absolute time limit and the impact of such a limit on negotiations are serious concerns. An absolute limit is a "second-best" solution. The best solution is for judges to police the time spent wisely in chapter. Perhaps the impetus to hold status conferences following from an express amendment to the Code would facilitate that result.

D. *Expedite Stay Relief*

A related problem is how to expedite stay-relief proceedings.[234] In many cases the determination on an application for stay relief serves as an early judgment on the feasibility of the case. This has been particularly true since the *Timbers* case, in which the Supreme Court in dictum approved the view that section 362(d)(2)(B)[235] includes a feasibility component.[236] Stay actions thus provide an opportunity for the court to terminate terminal cases at an early point.

But that function is realized only if the courts actually decide stay-relief motions expeditiously. The practice often is for stay-relief determinations to be delayed. Again, this contravenes the clear intent of Congress in 1978 to place strict time deadlines on applications for relief from the stay.[237]

Samuel Bufford, *Status Conferences in Chapter 11 Cases*, AM. BANKR. INST. J., Apr. 1993, at 14. For additional discussion of the role of the bankruptcy judge in case management, see Hon. Steven W. Rhodes, *Eight Statutory Causes of Delay and Expense in Chapter 11 Bankruptcy Cases*, 67 AM. BANKR. L.J. 287, 311-15 (1993). Judge Fenning predicted that by the end of the century, judges will routinely set deadlines for filing plans at the status conference, and will rarely extend the deadline. Fenning, *supra* note 10, at 116.

234. In supporting the 1992 legislation, Representative Fish grouped the goal of "facilitat[ing] more expeditious resolutions of requests for relief from the automatic stay" with the limitation of exclusivity, toward the end of limiting "the potential harm that can result from delay." 138 CONG. REC. H11,057 (daily ed. Oct. 3, 1992) (remarks of Rep. Fish).

235. 11 U.S.C. § 362(d)(2)(B) (1988) provides that relief shall be granted with respect to the stay of an act against property if the debtor lacks equity (§ 362(d)(1)) and "such property is not necessary to an *effective* reorganization." (emphasis added). The question is whether the reference to an "effective" reorganization adds a requirement independent of the "necessity" test.

236. United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 375-76 (1988).

237. *See* H.R. REP. NO. 595, *supra* note 2, at 175, *reprinted in* 1978 U.S.C.C.A.N.

Current section 362(e) provides that, with respect to the stay of any act against property of the estate, the stay will terminate by operation of law thirty days after the stay request, unless the court orders the stay continued in effect pending the conclusion of a final hearing.[238] The section then provides that the final hearing must be commenced within thirty days after the conclusion of the preliminary hearing.[239] However, section 362(e) is silent as to when that final hearing must be concluded. At one time, Rule 4001 contained another thirty-day provision, requiring the final hearing to be concluded within thirty days after it was commenced. However, that provision was dropped in 1991.[240]

Another proposed amendment to the Code would amend section 362(e) to change the provision that the final hearing be *commenced* within thirty days after the preliminary hearing to a requirement that the final hearing be *concluded* in that thirty-day period.[241] A similar provision was contained in the final version of S. 1985.[242] The version of S. 1985 that passed the Senate in June 1992 added the two thirty-day periods together and provided that the final hearing had to be concluded within sixty days after the filing of the request.[243]

As with the exclusivity cap, however, the question still remains whether the time limitation should be absolute or whether the bankruptcy judge should be given discretion to expand the time. All of the versions of section 362(e) proposed in the 102d and 103d Congresses opted to give the judge an out. In the version of S. 1985 that passed the Senate, the exception was

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at 6136 ("The bill . . . provides that unless the court acts quickly, the relief is automatic on request by a creditor. Too often today, court delay in handling requests for relief amounts to a complete denial of relief. . . . The bill prevents such action."); *id.* at 344, *reprinted in* 1978 U.S.C.C.A.N. at 6300 ("Subsection (e) provides a protection for secured creditors that is not available under present law. the subsection sets a time certain within which the bankruptcy court must rule. . . . If the court does not rule within 30 days from a request for relief from the stay, the stay is automatically terminated with respect to the property in question.").

238. 11 U.S.C. § 362(e).

239. *Id.*

240. Fed. R. Bankr. P. 4001(a)(2) (1987) (repealed 1991). The Advisory Committee Note to the 1991 change states that "Subdivision (a)(2) is deleted as unnecessary because of § 362(e) of the Code." FED. R. BANKR. P. advisory committee notes to 1991 amendments (1991).

241. S. 540, *Reported Version, supra* note 64, § 101 (to be codified at 11 U.S.C. § 362(e)).

242. S. 1985, *Final Version, supra* note 63, § 101 (to be codified at 11 U.S.C. § 362(e)).

243. S. 1985, *Passed Version, supra* note 57, § 304 (to be codified at 11 U.S.C. § 362(e)).

for a finding of "good cause."[244] The final version that came out of conference required a stronger showing of "compelling circumstances;"[245]this stricter standard has been incorporated in S. 540.[246] Again, as with the exclusivity limit, once an exception is allowed, the prospect of wholesale evasion of congressional intent presents itself.

Having said that, it nevertheless is probably not a good idea to require a final up or down decision in sixty days in every case. This is especially true given the need for the court to make a feasibility decision at the stay hearing. The problem would be less severe if the *Koopmans*[247] view that only necessity need be shown were the prevailing approach.

However, even if an absolute limit were enacted, courts still could get around it. One way would be to hold for the debtor at the final stay hearing, continuing the stay in effect for a limited period of time, conditioned on the provision of adequate protection. Since a stay-relief determination is not res judicata, such a holding would not finally and irrevocably decide the matter. Even if such an approach were not available, the court could invoke its section 105 powers and issue an injunction.

All in all, enactment of some sort of time limit on stay determinations probably is a good idea.[248] Doing so again might serve as a sort of congressional encouragement to judges to keep the ball rolling,[249] without really hurting any live cases. The benefits may be marginal, but the downside seems almost nonexistent.

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244. *Id.*

245. S. 1985, *Final Version*, *supra* note 63, § 101 (to be codified at 11 U.S.C. § 362(e)).

246. S. 540, *Reported Version*, *supra* note 64, § 101 (to be codified at 11 U.S.C. § 362(e)).

247. Empire Enters. v. Koopmans (*In re* Koopmans), 22 B.R. 395 (Bankr. D. Utah 1982).

248. The National Bankruptcy Conference supports the idea, as long as the court retains the ability to grant extensions when justified. *Statement of Position of NBC on S. 540*, *supra* note 210, at 9. Other groups, however, feel that the proposed amendment would deprive the court of needed flexibility by creating too stringent a standard for granting extensions. *See* CLEVELAND BAR ASS'N REPORT, *supra* note 220.

249. Representative Fish explained that the purpose of the proposed amendment would be "to provide parties with as much certainty as possible that final hearings on requests for relief from the automatic stay will be concluded expeditiously." 138 CONG. REC. H11,057 (daily ed. Oct. 3, 1992) (remarks of Rep. Fish). He then elaborated in some detail that the "compelling circumstances" test was to be taken seriously, and contemplated only such things as tornados and sick judges; crowded court dockets and vague promises of white knights would not suffice. *Id.*

E. Single-Asset Real Estate Cases

Single-asset real estate cases present distinct problems. Many bankruptcy observers feel that these cases have at best a marginal justification for being in Chapter 11 at all. Most of these cases are essentially two-party disputes, between the investors and the secured creditor. Accordingly, many courts have dismissed single-asset filings, either on a bad-faith analysis or by granting relief from the stay to permit the secured creditor to foreclose. Others, however, have not, and secured creditors have been tied up in court while the debtor tries to salvage its investment.

Several substantive rules make the problem more acute. One is the fact that, under *Timbers*, pendency interest need not be paid to the creditor if the debtor is undersecured,[250] which is almost always true in these cases. One possible reform is to overrule *Timbers*, which will be discussed below.[251]

Combined with the *Timbers* rule is the uncertain state of the new-value exception to the absolute priority rule.[252] If that exception is recognized, it becomes much easier for the debtor to cram down a plan over the objection of the secured creditor. The primary counter to this trend is the recent rulings in cases such as *Greystone*[253] and *Bryson Properties*,[254] which impose classification limits that may prevent the debtor from proposing a plan that satisfies section 1129(a)(10).[255] Another possible reform would be to tighten up the absolute priority rule and perhaps limit or eliminate the new-value exception.[256]

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250. United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 371 (1988).

251. *See infra* part V.G.

252. *See infra* part V.J.

253. Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991), *cert. denied,* 113 S. Ct. 72 (1992).

254. Travelers Ins. Co. v. Bryson Properties XVIII (*In re* Bryson Properties XVIII), 961 F.2d 496 (4th Cir.), *cert. denied,* 113 S. Ct. 191 (1992).

255. 11 U.S.C. § 1129(a)(10) (1988) requires at least one impaired class to accept the plan if any classes are impaired. In single-asset cases, the major creditor often is so undersecured that the unsecured portion of its claim gives it the power to control the unsecured class vote, thereby preventing the debtor from satisfying § 1129(a)(10) and confirming the plan. If the debtor is allowed to separate that undersecured creditor out into a another class, however, then the remaining trade creditors may well vote in favor of the plan.

256. To cram down a plan over the objection of a dissenting unsecured creditor class, the plan either must pay that class in full or must give nothing to classes junior to the dissenting class. 11 U.S.C. § 1129(b)(2)(B). This would mean that equity shares would be cancelled. The "new value" exception allows equity holders to retain an ownership interest in the reorganized debtor by contributing "new value" to the debtor. The theory is that the retained value is on account of the new contribution, not the old equity

Many approaches could be taken to deal with the single-asset problem. The most drastic would simply be to make single-asset debtors ineligible for Chapter 11 relief, as a blanket rule. Doing so would give effect to the notion that bankruptcy intervention is only necessary or appropriate to solve a collective action problem. Other less dramatic forms of intervention also have been suggested. S. 1985[257] and now S. 540[258] provide for limited relief for secured creditors, in the context of section 362. One change would be to add a new section 362(i), which would require the court to permit the creditor to continue a previously commenced foreclosure proceeding up to, but not including, the point of sale in a single-asset real estate case.[259] Under state law, the foreclosure process often involves a series of steps that take a certain discrete period of time. The problem creditors have encountered is that after they start the process, the debtor files Chapter 11 and stays the process; even when stay relief is granted, the entire remaining state statutory time period still has to run.[260] The proposed amendment simply would allow the creditor to run through the entire state foreclosure process during the bankruptcy case even while the stay was in effect, so that if the bankruptcy court does eventually decide to lift the stay, the foreclosure sale could occur immediately.[261] This change is a positive one, as it helps the creditor without really damaging the debtor, since the sale itself is still stayed until the court finds for the creditor under section 362(d).

S. 1985[262] and now S. 540[263] also would add a more controversial provision by enacting a new ground for stay relief in single-asset real estate cases as section 362(d)(3). Under this proposal, the debtor would be given a ninety-day grace period after filing. At the ninety-day mark, however, the stay would be lifted unless the debtor either (1) files a feasible plan, or (2) commences making monthly interest payments to the creditor.[264] In effect, if the debtor wants more than ninety days to work out a feasible plan, it would have to pay for the privilege. While this proposal did not survive into

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interest. *See infra* part V.J.

257. S. 1985, *Passed Version*, *supra* note 57, § 211(b) (to be codified at 11 U.S.C. §§ 362(d)(3), 362(i)).

258. S. 540, *Reported Version*, *supra* note 64, § 202 (to be codified at 11 U.S.C. §§ 101, 362(d), 362(i)).

259. *Id.* § 202(b)(2) (to be codified at 11 U.S.C. § 362(i)).

260. 138 CONG. REC. S8264-65 (daily ed. June 16, 1992) (remarks of Sen. Reid).

261. S. 540, *Reported Version*, *supra* note 64, § 202(b)(2) (to be codified at 11 U.S.C. § 362(i)).

262. S. 1985, *Passed Version*, *supra* note 57, § 211(b)(1) (to be codified at 11 U.S.C. § 362(d)(3)).

263. S. 540, *Reported Version*, *supra* note 64, § 202(b)(1) (to be codified at 11 U.S.C. § 362(d)(3)).

264. *Id.*

the final conference version of S. 1985,[265] it was resurrected in S. 540.[266] Its chief sponsor is Senator Grassley,[267] the ranking minority member on the Senate Judiciary Committee, who was responding to the pleas of institutional secured lenders, such as insurance companies, that they were being held up in Chapter 11 for indefinite periods without compensation. Whether one favors or disfavors the proposed section 362(d)(3) depends almost entirely on how one wants to cast the balance of power between the debtor and the secured creditor in single-asset cases.

F. *Require Threshold Feasibility Finding*

Another reform that has been suggested is to require the court to make a threshold finding that the Chapter 11 case is feasible. The projected benefit would be that hopeless cases could be exposed early on and would not be dragged out for extended periods of time. The dismal overall success rate of Chapter 11 cases suggests that a veritable army of candidates for early dismissal exist.

The Bankruptcy Code presently permits this form of relief, except that a hearing on feasibility is permissive rather than mandatory. Section 1112(b) authorizes the court to dismiss a case or convert it to Chapter 7 on request of a party in interest or the United States Trustee for "cause."[268] The "absence of a reasonable likelihood of rehabilitation"[269] is one of the enumerated statutory grounds for dismissing or converting a case. Furthermore, feasibility may be determined in a stay-relief hearing under section 362(d)(2)(B),[270] as noted above.

The proposal thus must contemplate that the existing permissive nature of the sections just mentioned undercuts their utility. It is difficult to see why this should be so, however. Both an independent overseer, the United States Trustee, and all parties in interest are authorized to put the feasibility issue before the court. If no one with a stake in the proceedings or the independent administrative officer is concerned enough about feasibility to bring the question to the attention of the court, why should we care? One of the official duties of the creditors' committee under section 1103 is to "investigate the financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such busi-

265. S. 1985, *Final Version*, *supra* note 63.

266. S. 540, *Reported Version*, *supra* note 64, § 202(b)(1) (to be codified at 11 U.S.C. § 362(d)(3)).

267. 138 CONG. REC. S8251 (daily ed. June 16, 1992) (remarks of Sen. Heflin).

268. 11 U.S.C. § 1112(b) (1988).

269. *Id.* § 1112(b)(1).

270. *Id.* § 362(d)(2)(B).

ness."[271] If the committee does not seek a dismissal or conversion, does that not suggest at least some belief in feasibility and some willingness to give the case a chance?

Perhaps not. What may be going on is that most creditors perceive that a section 1112(b) motion brought early in a large Chapter 11 case has little chance of succeeding. If that is true, there is no point in wasting the time and money to tilt at windmills. Many bankruptcy judges have a strong inclination to give the reorganization a try. Again, then, we are back in the realm of the bankruptcy court exercising its discretion in a way that frustrates the operation of the Chapter 11 system. One could argue that forcing the bankruptcy court to make an express feasibility finding will only add time and expense to the Chapter 11 case, without changing the results at all; the court still will routinely let cases proceed.

Yet, maybe we should not be so pessimistic. Judges generally view section 1112 as an extreme remedy, to be utilized only in extraordinary cases. If Congress were to enact a separate provision mandating a feasibility finding and make clear that the court's duty was to make an honest finding, it is possible that bankruptcy judges would honor the congressional directive and dismiss more cases. This latter scenario is more likely to come to pass if the feasibility determination is postponed for some period of time, so that the debtor is given some opportunity to put a plan together, or least make progress in that direction. A plausible candidate for the timing of the feasibility hearing would be at 120 days, to tie in with the 120-day exclusivity period.[272]

The feasibility determination would be more substantial if the United States Trustee were required to make a formal recommendation to the court on the issue. One of the stated justifications for a separate small-business chapter, be it a new Chapter 10 or a modified Chapter 13, is that an independent observer, the standing trustee, would be in a position to advise the court on the likelihood of reorganization.[273] A similar function could be carried out in Chapter 11. Under old Chapter X, the SEC performed this role,[274] but no longer does so in the same way under the Code.

The concern about an independent recommendation is, of course, the time and cost of the investigation that would be necessary. The staffs of the U.S. Trustee offices probably are not adequate at this point to take on such a task. An alternative possibility would be to farm out the job. The court could appoint an investigator (examiner?)[275] in each Chapter 11 case to

271. *Id.* § 1103(c)(2).

272. *Id.* § 1121(b).

273. S. REP. NO. 168, *supra* note 64, at 40.

274. Chandler Act, ch. 575, §§ 172-73, 52 Stat. 840, 890-91 (1938) (repealed 1978); *see* H.R. REP. NO. 595, *supra* note 2, at 225, *reprinted in* 1978 U.S.C.C.A.N. at 6185.

275. 11 U.S.C. § 1104(b) authorizes the court to appoint an examiner if the

study the debtor and make a formal recommendation on feasibility. This would of course significantly increase costs. The question would be whether the costs expended on the examiner would be outweighed by the savings from the mercy killings of terminal cases.

Another possibility would be to require the creditors' committee to make a formal report on feasibility. This would not require the creation of any new players and would allow the court to capitalize on the existing knowledge of creditors, who are the parties most likely to know the debtor's strengths and weaknesses. An objection would be that the creditors are not disinterested, and giving them a virtual veto over the reorganization would greatly shift the balance of power. Because of that factor alone, the creditors' committee approach probably would never be adopted.

A further problem is that it depends on an able and active creditors' committee. In some cases such a committee exists, but in many it does not; creditor apathy instead prevails.[276] Thus the committee in many instances would be forced to hire an independent financial examiner. If such a person is going to have to be hired anyway, it is probably preferable for them to report either to the court or to the U.S. Trustee, and not to one of the groups with a stake in the outcome of the proceedings.

G. *Compel Debtor to Pay Interest During Pendency of Case*

All of the proposals to save time and money that have been discussed so far look to Congress or the courts or perhaps to an independent administrator to ride herd on the case and keep it moving. The Supreme Court in *Timbers* suggested this tack as a palliative to its denial of interest to undersecured creditors.[277] This may be the wrong focus, however. In some respects this approach may be ill-fated from the start, for it involves an outside agency trying to impose restrictions on the affected parties. Far better, perhaps, is to structure the system so that the parties themselves had appropriate incentives to move the case along. As things now stand, however, those incentives may not exist. What has gone wrong, and what could be changed?

From the point of view of the debtor, perhaps the biggest, single enticement to stall is the fact that interest does not have to be paid during the pendency of the case.[278] This gives the debtor an enormous competi-

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"appointment is in the interests of creditors, any equity security holders, and other interests of the estate."

276. S. REP. NO. 168, *supra* note 64, at 40.

277. United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 376 (1988).

278. 11 U.S.C. § 502(b)(2) disallows a claim for interest that is unmatured at the time

tive advantage vis-à-vis its competitors.[279] It enables the debtor to hold up its creditors for a better deal in the plan. Combined with the virtually unshakable retention of exclusivity, the debtor can simply refuse to go forward until the creditors acquiesce in the debtor's plan, with the teeth behind the debtor's bluff being the deprivation of interest. Time is money, except in bankruptcy, and debtors are able to use that fact to their advantage. If the debtor had to pay interest during the case, that fact alone might (1) decrease the number of Chapter 11 filings, perhaps dramatically, and (2) discipline the debtor, in cases where it did file, to move expeditiously toward confirmation.[280]

So why not require debtors to pay pendency interest? The concern is that imposing such a requirement would kill off many marginal cases before they had a chance to get going. This result would frustrate the congressional policy favoring reorganizations. One reason many debtors end up filing Chapter 11 is that they are cash poor and cannot service their debt. While in some cases the debtor is able to negotiate a voluntary suspension of interest payments, the bank is not forced to agree to such a suspension. If the bank does not agree, and the debtor lacks the money to make the payments, what happens? It would do those debtors little good to permit them to file Chapter 11 but then to require them to do the impossible and pay the debt service they cannot pay. The theoretical benefits of Chapter 11 discussed at the start of this paper would be available only at the whim of the debtor's bank. To date, reorganization policy makers have been unwilling to grant such a veto power to secured lenders. In light of the language quoted earlier in the 1977 House Report,[281] it is unlikely that Congress will be inclined to change its stance on this issue.

To be sure, persuasive advocates have urged that the reorganization should not be attempted at the expense of secured creditors, who, they claim, do not really have a stake in the outcome. Professors Baird and Jackson are the primary proponents of this view.[282] If the residual claimants, be they equity or unsecured creditors, want to attempt a reorganization, then those claimants should have to bear the real cost of doing so. If they are not forced to pay, then, the argument goes, assets will be deployed inefficiently. Furthermore, a wealth transfer from senior claimants to

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the case is commenced.

279. *See* Greenwald, *supra* note 16, at 60.

280. *See* Rosen, *supra* note 14, at 49.

281. *See* H.R. REP. NO. 595, *supra* note 2, at 220, *reprinted in* 1978 U.S.C.C.A.N. at 6179.

282. 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).

residual claimants will occur, a result not necessary to the collective action justification of bankruptcy relief.

The Supreme Court in *Timbers* rejected the Baird and Jackson argument in the context of an undersecured creditor. Thus, after *Timbers*, any requirement that the debtor pay interest during the case would require an amendment to the Code. The Court did not really focus on the broader issues of the normative bases for a reorganization policy, but limited its discussion more to an interpretation of the various Bankruptcy Code provisions.

The Baird and Jackson view adopts a limited perspective on the function of Chapter 11 proceedings. To them, the only thing that should matter is maximization of asset value.[283] Other commentators, such as Professor Elizabeth Warren, suggest that Congress had a broader public interest in mind when it enacted the reorganization provisions, and that such an orientation is proper.[284] In keeping with this attitude, forcing some creditors to take a hit in the form of foregone interest payments is justifiable on a public interest basis.

At this point in time, however, it may be plausible to suggest that the argument in favor of forcing debtors to pay interest may be supportable even if a broader public interest focus is taken. The high failure rate of Chapter 11 cases and the long delays in Chapter 11 do more than hurt individual creditors. They subvert the very public interest supposedly to be served. Large deadweight losses help no one. Compelling debtors to pay interest might serve the function of ferreting out the more viable debtors from those who really have no realistic hope of survival. In addition, debtors would then have an incentive to speed their case along.

I recognize that the pro-reorganization sentiment and the perception that many debtors probably could not pay interest right away would probably doom the chances that a provision requiring interest to be paid from day one would pass.[285] A compromise might be possible, however, which would allow debtors some breathing room and a chance to get back on their feet, and yet, at the same time, light a fire under debtors to proceed apace. That compromise would be for an interest moratorium to be imposed for some defined period of time—120 days, six months, one year—but then for the interest obligation to resume on a current basis when the moratorium period expired.[286] Perhaps the moratorium period could be coordinated with the

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283. JACKSON, *supra* note 5, at 210; Baird, *World Without Bankruptcy*, *supra* note 5, at 183-84.

284. Warren, *Bankruptcy Policy*, *supra* note 8, at 787-88.

285. The National Bankruptcy Conference has not been able to reach consensus on the question and notes that such a requirement would be "extremely controversial." *Statement of Position of NBC on S. 540*, *supra* note 210, at 28.

286. An analogous proposal is made in S. 540 in the specific context of stay relief in

exclusivity period and a feasibility finding. If one were really adamant that no reallocative effects should occur, the interest could also accrue during the moratorium period, with payment deferred to the plan. Requiring accrual would be even more compelling in the event the debtor were found to be solvent.

H. Reduce Number of Committees and Their Fees and Expenses

It would be a mistake to lay all the fault for the delays and expense of Chapter 11 at the feet of debtors, however. Sharing the blame is the current committee system.[287] Once committees proliferate, bargaining becomes more difficult. Also, if the fees of committee professionals and the expenses of committee members are freely paid, then those groups have little incentive to bring the case to a rapid conclusion. The counter-argument is that vigorous committee participation is vital to the effective operation of a Chapter 11 case.

One thing that bankruptcy courts can do is to resist the demand to appoint multiple committees within a single case.[288] A big question here is whether an equity committee should routinely be appointed. Professors LoPucki and Whitford have shown that when an equity committee is appointed, the chances that equity will receive something in the plan goes up markedly.[289] This may or may not be viewed as a problem. However, when an equity committee is in place, the bargaining process is made more complicated and can be drawn out, thereby costing time and money.

Within the creditor ranks, courts also can resist the temptation to appoint multiple committees.[290] The savings would be in fees and in reducing bargaining costs. The downside, of course, is that a particular group may be underrepresented. Adequate representation might be achieved within the confines of the official committee, by placing enough representatives of different groups on the committee.

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single-asset real estate cases. The suggested amendment would require interest to be paid to the secured creditor in a single-asset real estate case beginning 90 days after the filing of the case, unless the court ordered otherwise for cause. S. 540, *Reported Version*, *supra* note 64, § 202(b)(1) (to be codified at 11 U.S.C. § 362(d)(3)(B)). The proposal made in the text here would be of general applicability to all Chapter 11 cases, not just those involving single-asset real estate, and also would not be limited to the automatic stay context.

287. *See* Jost, *supra* note 16, at 32; Rosen, *supra* note 14, at 48.

288. Under 11 U.S.C. § 1102(a)(2) (1988), the court on request of a party in interest may order the appointment of additional committees "if necessary to assure adequate representation" of creditors or equity holders.

289. LoPucki & Whitford, *Equity's Share, supra* note 9, at 159.

290. *See* Rosen, *supra* note 14, at 48.

Even if multiple committees are appointed, savings might be realized by authorizing the committees to share professionals.[291] Much of the work of committee professionals overlaps. In many cases, the work of professionals, such as accountants and investment bankers, could be shared by different committees. Whether attorneys could be shared is a difficult question. The attorney is an advocate for the group he or she represents. If the initial appointment of the committee was justified because of a diversity in interests between creditors or interest holders, then one could argue that an attorney could not represent the diverse groups without running into impossible conflicts of interest.[292] Perhaps the committees could be given the power to waive the conflict in advance.

The same problem occurs in multiple cases involving affiliated debtors. The language of the Code[293] and the practice of most courts require separate committees and separate professionals for each case. In some instances, as where cross-corporate claims may exist, actual or potential conflicts of interest may make the multiple committee and professional approach necessary. At the same time, it may be advisable to amend the Code to give the court the power to merge committees or permit the sharing of professionals in related cases, when the prospect for conflicts of interest is less apparent.

This does not speak to the question of fees. The problem of professional fees in general will be discussed in the next subpart. In the committee context, one thought is whether the fees of the professionals should automatically be paid by the bankruptcy estate, as they currently are.[294] Perhaps the "substantial contribution" rule of section 503(b)(3) and (4) should be extended to official committees as well.[295] This concern pertains especially with regard to committees that represent out-of-the-money

291. *See id.*

292. 11 U.S.C. § 1103(b) provides that a professional employed by a committee "may not represent any other entity having an adverse interest in connection with the case."

293. *Id.* § 1102(a)(1) ("shall appoint a committee"); *id.* § 1103(a) ("such committee" may hire professionals); *see* H.R. REP. NO. 595, *supra* note 2, at 235, *reprinted in* 1978 U.S.C.C.A.N. at 6195 ("There will be at least one committee in each case.").

294. 11 U.S.C. § 503(b)(2) allows as a first priority administrative expense payable out of the bankruptcy estate "compensation and reimbursement awarded under section 330(a)." In turn, 11 U.S.C. § 330(a) permits compensation for fees and reimbursement of expenses "to a professional person employed under section 1103." The employment of professionals by committees, finally, is governed by 11 U.S.C. § 1103(a).

295. *See* Whitman, *supra* note 10, at 856-58. 11 U.S.C. § 503(b)(3)(D) authorizes the court to allow as an administrative expense the actual, necessary expenses incurred by a creditor or an unofficial committee "in making a substantial contribution" to the Chapter 11 case. Official committees are, however, expressly excluded from § 503(b)(3). Compensation for professionals of an entity that qualifies for priority under § 503(b)(3) may be allowed by the court under 11 U.S.C. § 503(b)(4).

constituencies.[296] If those groups had to pay for their counsel out of their own pockets, they might take a more considered posture in the case. If they make a positive contribution to the case, administrative priority may be obtained under section 503(b)(3) and (4). As things now stand, however, underwater committees have every incentive to stall the case: their counsel is free to them, and, if they wait long enough, either the debtor's finances may improve so that they come into the money, or senior claimants may throw them a bone to get them to go away.

Of course, it might be difficult to ascertain which groups are in, and which are out of, the money. Thus, a rule premised on that distinction might be difficult and costly to apply. The uncertainty also might have a chilling effect on committee involvement in the case. To the extent that committees took a less active posture, debtor control over the case would increase.

The only legislative steps taken in this area would call for more expenses for committee work, not less. All of the reform bills in the 102d and 103d Congress would amend section 503(b) to allow administrative priority for the actual and necessary expenses of committee members.[297] The intent is to clarify existing law and to encourage the full and active participation of committees. The idea that fees and expenses of committees should be restricted, not expanded, has not been seriously considered by Congress. The experience of leading practitioners suggests that this avenue could be profitably explored more closely.

I. Reduce Professional Fees

One means of reducing costs that has been explored in great detail is cutting down on the allowance of professional fees.[298] Senator

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296. *See* Rosen, *supra* note 14, at 48-49.

297. S. 540, *Reported Version*, *supra* note 64, § 111 (to be codified at 11 U.S.C. § 503(b)(7)). The same proposal was made in the 1992 legislation. S. 1985, *Final Version*, *supra* note 63, § 113 (to be codified at 11 U.S.C. § 503(b)(7)).

298. To illustrate, an entire issue of the *American Bankruptcy Institute Law Review* (vol. 1, number 2, Winter 1993), was devoted to the topic *Paying the Piper: Rethinking Professional Compensation in Bankruptcy*. Some of the articles include: *The Costs of Bankruptcy: A Roundtable Discussion*; Jay L. Westbrook, *Fees and Inherent Conflicts of Interest*, 1 AM. BANKR. INST. L. REV. 287 (1993); Hon. Alexander L. Paskay & Frances P. Wolstenhome, *Chapter 11: A Growing Cash Cow—Some Thoughts on How to Rein in the System*, 1 AM. BANKR. INST. L. REV. 331 (1993); Martin J. Whitman & David M. Barse, *Professionals Paid by Debtors Ought to Represent the Debtors' Interests*, 1 AM. BANKR. INST. L. REV. 367 (1993); Hon. Roger M. Whelan et al., *Professional Compensation Reform:: New Ideas or Old Failings?*, 1 AM. BANKR. INST. L. REV. 407 (1993); Note, *Professional Fees in Bankruptcy*, 1 AM. BANKR. INST. L. REV. 449 (1993); Gregory W. Bachman, Note, *Professional Fees in Bankruptcy: Tailoring the Johnson Factors to Suit Bankruptcy*, 1 AM. BANKR. INST. L. REV. 453 (1993); Gerard

Metzenbaum has done his best to make professional fees in Chapter 11 cases a cause celebre.[299] The populist sentiment of the day is that some of the only groups to benefit from Chapter 11 are the lawyers and accountants who earn big fees in reorganization cases.[300] Both Congress[301] and the popular press[302] like to call attention to cases like LTV, where attorneys' fees have surpassed $100 million. In many instances, however, Professor Warner may be accurate in observing that "conclusions are frequently reached, court decisions rendered and laws enacted on the basis of little more than individual perceptions and visceral reactions."[303]

There is no question that large attorneys' fees create problems, both as a matter of public perception about the integrity of the bankruptcy system[304] and as a burden on the reorganization case itself. The reform

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Di Conza, Note, *Professional Fees in Bankruptcy: The Use of the Lodestar*, 1 AM. BANKR. INST. L. REV. 463 (1993); Christine Jagde & Mamie Stathatos, Note, *Professional Fees in Bankruptcy: Percentage-of-the-Recovery Method—A "Solvent" Response for Bankruptcy Proceedings?*, 1 AM. BANKR. INST. L. REV. 471 (1993).

A very comprehensive and useful study of the entire topic is found in AMERICAN BANKRUPTCY INSTITUTE, NATIONAL REPORT ON PROFESSIONAL COMPENSATION IN BANKRUPTCY CASES (G.R. Warner rep. 1991) [hereinafter REPORT ON PROFESSIONAL COMPENSATION].

299. For a sample of Senator Metzenbaum's salvos fired at bankruptcy attorneys, see 138 CONG. REC. S8340-41 (daily ed. June 17, 1992) (remarks of Sen. Metzenbaum). The sponsor of the 1992 reform legislation noted that the provision on attorneys' fees was included at the suggestion of Senator Metzenbaum, "who has been at the forefront of this question." 138 CONG. REC. S8253 (daily ed. June 16, 1992) (remarks of Sen. Heflin); *see* Jost, *supra* note 16, at 32.

300. To illustrate the breadth of the opprobrium heaped on lawyers in bankruptcy cases, even Senator Dole, not exactly the arch-populist of the Senate, stated:

> The committee hearing held on the issue of professional fees in bankruptcy cases indicated that there is a lot of abuse out there. Cases were found which showed forum shopping to locate cases in jurisdictions where fees are less carefully scrutinized by the court [author's note: *Greyhound*, no doubt!]. . . . I suspect that all this is just the tip of the iceberg. . . . [T]he current state of affairs nonetheless leads many creditors caught up in the bankruptcy system to legitimately wonder who the system is working for. Indeed, what is the point of a bankruptcy system that enriches the professionals and leaves the creditors holding the bag.

138 CONG. REC. S8280 (daily ed. June 16, 1992) (remarks of Sen. Dole).

301. 138 CONG. REC. S8340 (daily ed. June 17, 1992) (remarks of Sen. Metzenbaum) (drawing attention in particular to the interesting billing category of "passive travel, a term the firm used to refer to the time lawyers spent sleeping or reading a magazine while on a plane en route to a bankruptcy meeting").

302. *See* Greenwald, *supra* note 16, at 61; Henwood, *supra* note 16, at 360; Passell, *supra* note 16, at C9; Wechsler, *Money to Burn?*, *supra* note 16, at 72.

303. REPORT ON PROFESSIONAL COMPENSATION, *supra* note 298, at 1.

304. Senator Grassley quoted from a speech given by Chief Justice Rehnquist to the

legislation being considered would amend section 330 of the Code to provide for very detailed guidelines for courts to consider in setting fees.[305] Factors to be considered would include:

> (I) the time spent on such services; (II) the rates charged for such services; (III) whether the services were necessary in the administration of or beneficial toward the completion of a case under this title; and (IV) the total value of the estate and the amount of funds or other property available for distribution to all creditors both secured and unsecured.[306]

The stated purpose of these specific guidelines is to force courts to scrutinize fee applications very carefully; the real purpose probably is to cut fee allowances.

I am not confident that adopting more particularized guidelines for fees will accomplish much good.[307] Depending on how the guidelines are interpreted, that approach might result in only a very modest nibbling away at fees allowed—and at considerable expense in terms of judicial time and effort to review massive fee applications. It is a myth to suggest that courts are not already closely policing bankruptcy fees; they are.[308]

Two things might make a difference. One would be for Congress to retreat from its basic position rejecting the principle of economy that prevailed under the Act.[309] It has been suggested that the proposed amendment might do just that.[310] The other would be for courts to give

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effect that large attorneys' fees "have become a potent source for controversy when combined with the increasing criticism that lawyers' and experts' fees often swallow up large portions of an estate's assets, leaving little behind for creditors." 138 CONG. REC. S8254 (daily ed. June 16, 1992) (remarks of Sen. Grassley) (quoting Chief Justice Rehnquist).

305. S. 540, *Reported Version*, *supra* note 64, § 309 (to be codified at 11 U.S.C. § 330(a)).

306. *Id.* (to be codified at 11 U.S.C. § 330(a)(2)(A)(ii)).

307. The National Bankruptcy Conference announced *unanimous* opposition to the proposal in S. 540 to amend § 330(a). *Statement of Position of NBC on S. 540*, *supra* note 210, at 53.

308. Fees in bankruptcy cases may already be lower than in other areas of practice. REPORT ON PROFESSIONAL COMPENSATION, *supra* note 298, at 3. Professor Warner found "a high level of vigilance" in policing professional fees. *Id.*

309. *See* 124 CONG. REC. H11,091-92 (daily ed. Sept. 28, 1978) ("Notions of economy of the estate in fixing fees are outdated and have no place in a bankruptcy code."); 124 CONG. REC. S17,408 (daily ed. Oct. 6, 1978) (same); H.R. REP. NO. 595, *supra* note 2, at 329-30, *reprinted in* 1978 U.S.C.C.A.N. at 6286 ("The effect . . . is to overrule . . . cases that require fees to be determined based on notions of conservation of the estate and economy of administration.").

310. Whelan et al., *supra* note 298, at 407; ABI LEGIS. BULL. (Am. Bankr. Inst.,

greater emphasis to factors IV and III above, in that order, and less to hours (I) and rates (II). As long as time expended multiplied by hourly rates remains the baseline, bankruptcy fees will remain very high, and yet positive results might not be forthcoming. Comparable fees in non-bankruptcy cases are very high, and big Chapter 11 cases take a lot of time. If, however, courts shake the "time is money" mentality and look at what is left in the estate, and what the lawyers did to bring that about, more significant changes could be possible. For example, if only $5 million is left at the end of the case to distribute to creditors, a court would be justified in denying attorney's fees of $4 million, computed on an "hours times rate" basis.

If lawyers knew that they would ultimately be answerable (in terms of their fees allowed) for the value of the estate, and that their recovery would be based on a percentage of the estate, several positive things might happen[311] (apart from the simple disallowance of large fees). If the case did not look promising, lawyers would not be inclined to pour a lot of time into that case in a probably vain attempt to reorganize. This could lead to quicker termination of doubtful cases. Furthermore, even more promising cases might be concluded more quickly, with less delay in negotiations. The lawyers would know that they would not necessarily be compensated for every hour spent, and thus would have no reason to churn hours. The moral hazard inherent in a pay-by-the-hour system would largely be obviated.

The counterargument is that all that would be accomplished by restricting attorneys' fees is that qualified lawyers would shun the bankruptcy arena and move to more profitable areas of practice.[312] This in turn would hamper the smooth operation of the complex bankruptcy system. Admittedly, there is at least some truth in this line of argument. But, it must be balanced against the inequities prevalent under the currently prevailing system.

It is always politically easy to pick on lawyers. It happens from both sides of the aisle. So, any bankruptcy reform bill that is passed in the near future is likely to have a similar fee provision. Lawyers, beware.

J. Absolute Priority and New Value: What to Do?

One of the hottest topics in the bankruptcy field today is the status and operation of the absolute priority rule[313] and the new-value

Washington, D.C.), Sept. 20, 1993.

311. The "percentage-of-recovery" method of calculating fees is espoused in Jagde & Stathatos, *supra* note 298, at 471-77.

312. *See* S. REP. NO. 279, 102d Cong., 2d Sess. 54 (1992) (additional views of Sen. DeConcini); Whelan et al., *supra* note 298, at 408.

313. This rule only allows junior claimants to participate in a reorganization if senior

"exception."[314] Much has been written; it is not my intention to reinvent the wheel and join full force in that debate. My perspective is rather on how the absolute priority rule impacts on the Chapter 11 process, and what changes might be made that could improve the overall operation of Chapter 11.

One of the critical congressional decisions in 1978 was to apply the absolute priority rule only in a cramdown plan.[315] The rigid adherence to the rule required in Chapter X was abandoned. The need for a full-scale valuation of the debtor's business was felt to be wasteful and costly, besides being very uncertain.[316] Thus, Congress decided to permit senior claimants to agree to give up value to junior claimants, in order to avoid the high costs of litigating valuation, and "to expedite or insure the success of the reorganization." [317] In a consensual plan, only the best-interests test, which insures each claimant at least liquidation value, applies.[318]

Studies have shown that absolute priority is routinely violated in Chapter 11 cases.[319] But one may ask, so what? The concern is that equity holders, even when their class is clearly underwater, can disrupt and delay plan negotiations by demanding a share of the reorganization pie as the price of avoiding a valuation hearing. Creditor interests have no effective means of making these equity nuisances go away, except to pay them off.[320]

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claimants are paid in full. Under the Code, this rule only operates if a class dissents, forcing cram down under § 1129(b). 11 U.S.C. § 1129(b)(2)(B), (C) (1988). Furthermore, the rule only operates from the dissenting class down, meaning that senior classes still remain free to give up value to each other, as long as no class receives more than full payment.

314. The "new value" exception allows equity holders to retain (obtain?) an ownership interest in the reorganized debtor even if their class is under water, based on a contribution of new value to the reorganized entity. This participation is justified as being allowed on account of the new money, not the old equity interest.

315. 11 U.S.C. § 1129(b); *see* H.R. REP. NO. 595, *supra* note 2, at 224, *reprinted in* 1978 U.S.C.C.A.N. at 6184 ("Only when the parties are unable to agree on a proper distribution of the value of the company does the bill establish a financial standard. . . . The rule is a partial application of the absolute priority rule . . . .").

316. *See* H.R. REP. NO. 595, *supra* note 2, at 222, *reprinted in* 1978 U.S.C.C.A.N. at 6181 (stating that "the length and uncertainty of the valuation process is no longer justified in every case"; also, quoting Peter Coogan's observation that "such a valuation is usually 'a guess compounded by an estimate'").

317. *See id.* at 224, *reprinted in* 1978 U.S.C.C.A.N. at 6184.

318. 11 U.S.C. § 1129(a)(7); *see* H.R. REP. NO. 595, *supra* note 2, at 224, 412, *reprinted in* 1978 U.S.C.C.A.N. at 6183-84, 6368.

319. *See, e.g.,* Altman, *supra* note 10, at 7; LoPucki & Whitford, *Equity's Share, supra* note 9, at 142-43; LoPucki & Whitford, *Preemptive Cram Down, supra* note 9, at 626-27; Weiss, *supra* note 48, at 294.

320. *See* LoPucki & Whitford, *Equity's Share, supra* note 9, at 143-58; LoPucki &

One solution that has been proposed by LoPucki and Whitford is for the bankruptcy court to enter a "preemptive cram down" order early in the case to extinguish the interests of clearly insolvent equity or even junior debt classes.[321] This would have several beneficial effects, they claim, without impairing any substantive rights of the affected classes. The extinguished classes would no longer be parties in interest in the Chapter 11 case, and thus would not be entitled to participate in plan negotiations or appear and object at hearings. Nor would those classes be entitled to organize committees and hire professionals at the expense of the bankruptcy estate.[322]

LoPucki and Whitford are careful to point out that entry of a preemptive cram-down order would not prevent senior creditors from permitting extinguished equity holders to share in the plan.[323] They may want to do so to keep the expertise of particular managers, or to help create a market for the securities of the reorganized company. The new-value exception would not be affected, because it is not based on the old equity claim, but on a new contribution of value.[324]

The proposal suggested by LoPucki and Whitford has substantial merit, and should be carefully considered. As they point out, equity holders would not be deprived of any substantive right, for creditors still can insist on the application of the absolute priority rule. All that would happen is that the delays and expenses caused by obstructionist equity tactics could be readily eliminated by entry of a preemptive cram-down order.

What to do with the controversy over the new-value exception is another matter. The Supreme Court has granted certiorari in the case of *In re Bonner Mall Partnership*,[325] in which the Ninth Circuit held that the new-value exception survived the enactment of the Code. Certainty here would be worth a lot.[326] Litigation over uncertainty and bargaining in the shadow of unclear legal rules create significant costs. Once those uncertainty costs are eliminated, however, I do not think that it makes much difference for Chapter 11 practice whether the exception exists or not. If no new-value exception were permitted, then creditors would have a yet stronger case for controlling the outcome of single-asset cases. The ultimate outcome as between debtor and creditor, however, is less important for my purposes

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Whitford, *Preemptive Cram Down, supra* note 9, at 628-32.

321. LoPucki & Whitford, *Preemptive Cram Down, supra* note 9, at 633-35.

322. *Id.* at 634-35.

323. *Id.* at 635.

324. *Id.* at 644-46.

325. Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (*In re* Bonner Mall Partnership), 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681 (1994).

326. *See* Rhodes, *supra* note 233, at 290.

here than are the systemic effects of the rule.

K. Make Prepackaged Plans Easier to Confirm

One device that has become more popular in the 1980s and 1990s is the prepackaged plan, or "pre-pack."[327] In a pre-pack, the terms of the plan are agreed to, and the acceptances are solicited and obtained, prior to the filing of the bankruptcy case. A Chapter 11 case is then filed in order to confirm the previously agreed-to plan and thereby bind dissenting creditors to the plan's terms. The previously obtained acceptances are used in the Chapter 11 plan confirmation process. The big advantage of a pre-pack is that the case can be in and out of bankruptcy court very quickly, and thus the costs of the proceeding are correspondingly low.

Pre-packs have been used most often in cases where the business itself is sound, but the capital structure of the debtor needs to be revised. A common example is when the debtor was the subject of a leveraged buyout and now needs to revise its obligations to its junk bond holders.[328] What happens is that an exchange offer is made to the bondholders outside of bankruptcy, with the instruction that acceptances may be used in a Chapter 11 case.

The Bankruptcy Code and Rules currently permit prepackaged plans. Section 1126(b) states that the prepetition acceptances may be used if the solicitation complied with any applicable nonbankruptcy disclosure rules[329] (*e.g.*, the Securities Exchange Act of 1934), or, if none, after disclosure that meets the adequate information test of Bankruptcy Code section 1125(a).[330] Rule 3018(b) requires the transmission of the plan to substantially all members of the same class (but not all members of all classes), and that the time given for acceptance not be "an unreasonably short time."[331]

The *Southland* case exposed some problems with the legal rules governing pre-packs.[332] Those problems should be clarified, especially given the prospect of even more pre-packs being filed in the aftermath of the LBO craze of the 1980s. Pre-packs also may be a useful way to deal with

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327. *See* Mark E. MacDonald & Arthur E. Stewart, *Trend: Prepackaged Bankruptcies and LBOs*, 21 Bankr. Ct. Dec. (CRR) at A1 (Mar. 7, 1991); Patrick A. Murphy, *Prepackaging: Plans Can Succeed, Sometimes*, NAT'L L.J., Apr. 15, 1991, at 19; Weinstein, *supra* note 86, at 13.

328. *See* Murphy, *supra* note 327, at 25-26; Weinstein, *supra* note 86, at 13.

329. 11 U.S.C. § 1126(b)(1) (1988).

330. *Id.* § 1126(b)(2).

331. FED. R. BANKR. P. 3018(b).

332. *In re* Southland Corp., 124 B.R. 211 (Bankr. N.D. Tex. 1991). For a discussion of that case, see Claudia MacLachlan, *Prepackaged Bankruptcy Stumbles*, NAT'L L.J., Jan. 28, 1991, at 1.

single-asset real estate cases, of which there are many. In *Southland* Judge Abramson overturned the use of prepetition acceptances for several reasons. One was that the votes were obtained from record holders of the securities, who are not necessarily the same as the beneficial holders.[333] Second was the finding that an unreasonably short time (eight business days) was given for voting.[334] Finally, in dictum the judge noted the difficulties that a debtor may face in trying to comply with the amorphous disclosure standard of section 1126(b).[335]

These problems could be dealt with in several ways. First, the Bankruptcy Code could be amended to clarify that a vote by record holders of securities is sufficient. Second, Rule 3018(b) could be amended to specify an exact time period that must be given for returning votes. This would enable debtors to know with certainty that they have satisfied the timing problem; there does not appear to be any good reason to have an open-ended "unreasonably short time" test.

Finally, Congress may want to rethink the reference in section 1126(b)(1) to nonbankruptcy disclosure rules and may want to provide debtors with some mechanism for obtaining prior approval of the disclosure materials. If votes can be solicited in a Chapter 11 case without complying with nonbankruptcy securities laws, but only with section 1125 of the Bankruptcy Code, it would seem plausible to permit a debtor to do the same when the votes solicited will be used to confirm a Chapter 11 plan, even though the solicitation itself occurred prior to Chapter 11. Of course, if Chapter 11 were not invoked, nonbankruptcy securities laws would have to be followed in effecting an exchange offer. That fact might lead debtors to go ahead and comply with the securities laws anyway, so that the exchange offer will be valid without resorting to Chapter 11 if enough acceptances are obtained.

Assuming that section 1126(b)(1) were repealed, and that only section 1125 disclosure would be required, efficiency still would be promoted if debtors knew in advance of the solicitation that their disclosure was adequate. Otherwise, as Judge Abramson noted in *Southland,* debtors are playing "Russian Roulette" with the adequacy of prepetition disclosure.[336] What I propose is permitting a presolicitation court approval of the disclosure statement. The Code could be amended to permit the debtor to file a declaratory judgment action as to the adequacy of the section 1125 disclosure in the bankruptcy court. If these changes are made, the confirmation of prepackaged plans would be simpler and more certain, which in turn

333. *Southland,* 124 B.R. at 220-25.

334. *Id.* at 227.

335. *Id.* at 225-26.

336. *Id.*

might encourage greater use of the process.

L. *Facilitate Major-Asset Sales*

Earlier in this Article, I rejected the view that Chapter 11 should be repealed and replaced by a mandatory-auction system. It should be emphasized, however, that my concerns focused on the mandatory aspect of the proposal, not on the efficacy of auction sales. It is indisputable that, in many instances, a sale is to be preferred to an internal reorganization with a "hypothetical" sale to existing creditors and equity holders. A sale establishes a precise and hopefully accurate value and can often be accomplished much more rapidly and inexpensively than a negotiated plan. An actual sale neatly bifurcates the issues of how the assets should be deployed and how the value of those assets should be distributed to claimants. My concern simply was that these benefits of a sale are not realizable in every case, and that a compulsory sale rule would be counterproductive in those instances.

I do think that the Bankruptcy Code could be profitably amended by facilitating major-asset sales under section 363(b)(1),[337] even if the proposed sale covers all or substantially all of the debtor's assets. Under current law the ability of a debtor to effectuate such a sale outside of a confirmed plan is somewhat uncertain and is definitely limited. The controlling presumption is that a sale of substantially all assets should only take place in a confirmed Chapter 11 plan or in a Chapter 7 case. In the Chapter 11 setting, the theory is that creditors and equity holders should not be deprived of the rights provided to them in the plan confirmation process, especially disclosure under section 1125 and voting under section 1126. In a Chapter 7 case, an independent disinterested trustee runs the sale, supposedly protecting interested parties and ensuring fairness.

Courts in Chapter 11 have developed a variety of tests to gauge whether a substantial asset sale should be approved outside of the confirmation process. The leading case is *Lionel*,[338] in which the Second Circuit demanded a "business justification" for the sale. The insistence of the creditors' committee was held not to be a sufficient justification. The court also enunciated a list of factors to be considered in deciding whether to approve the sale.

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337. All that 11 U.S.C. § 363(b)(1) (1988) says is that the trustee (or DIP, 11 U.S.C. § 1107(a)), after notice and a hearing, may sell property of the estate other than in the ordinary course of business. No further limits are imposed. As the text explains, however, courts have added restrictions.

338. Committee of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983).

Other cases have taken a stricter view. For example, the *White Motor*[339] court demanded a showing of emergency as a predicate to approval of a pre-plan substantial-asset sale. Another concern is whether the court will deny approval of the sale on the ground that the entire transaction goes beyond a mere sale and effectively constitutes a sub rosa plan. The Fifth Circuit's decision in *Braniff*[340] is the leading case on that issue.

I assert that the presumption against a pre-plan sale should be reversed. Sales should be encouraged as much as possible. If the debtor wants to make the sale, then unnecessary roadblocks should not be imposed. Certainly adequate notice and an opportunity to be heard should be given to all interested parties of the proposed sale, in conjunction with Rules 2002[341] and 6004.[342] As long as those procedural hurdles are satisfied, however, I see no reason why substantive objections should be raised beyond the question of whether the price proposed is fair. This issue of course would encompass not only valuation evidence, but also matters such as how the property was marketed, whether any insiders have connections to the purchaser, and so forth. Objecting parties could appear at the hearing and present evidence as to why the sale was unfair, and the court could take those objections under consideration. If the creditors' committee objected to the sale, the court probably would ascribe great weight to their objection. All in all, however, I fail to see the benefits of a creditor vote when an actual market sale is being contemplated. No such vote occurs in Chapter 7 sales.

One concern that might be raised is that creditors and equity holders would be deprived of a vote not only on the merits of the sale, but on the fact of the sale itself. In other words, what if creditors or equity holders want to keep the assets and attempt an internal reorganization, rather than

339. *In re* White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981).

340. Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935 (5th Cir. 1983).

341. FED. R. BANKR. P. 2002(a)(2) requires giving 20 days' advance notice by mail of a proposed sale out of the ordinary course of business, but does give the court flexibility for cause shown to shorten the time or direct another method for giving notice. Rule 2002(c) elaborates on the content of the required notice, which must include the time and place of any public sale, the terms and conditions of any private sale, and the time fixed for filing objections. General descriptions of property are allowed. FED. R. BANKR. P. 2002(c).

342. Rule 6004 gives detailed procedural requirements, in addition to those specified in Rule 2002, for non-ordinary course sales of property. FED. R. BANKR. P. 6004 (1993). That rule covers the requirement of notice (Rule 6004(a)); the filing of objections (Rule 6004(b)); sales free and clear of liens (Rule 6004(c)); sales of property under $2500 (Rule 6004(d)); a hearing (Rule 6004(e)); and the conduct of the sale (Rule 6004(f)). One point of interest is that the rule only requires a hearing to be held if a timely objection is filed. FED. R. BANKR. P. 6004(e).

liquidate? A short answer is that creditors and equity holders do not have the right to vote on a reorganization under the Code. Under section 1112(a) a Chapter 11 debtor-in-possession ("DIP") has an absolute right to convert to Chapter 7, except in circumstances not relevant here.[343] While creditors can move for a conversion back to Chapter 11, the granting of that request is within the court's discretion.[344] That being said, then, it does not appear that creditors have lost any rights if the court at the Chapter 11 sale hearing weighs and determines arguments on the pros and cons of reorganization versus liquidation. To insist on a conversion to Chapter 7 seems foolish.

Indeed, the bigger problem may be not a reluctance of creditors to agree to a sale when the debtor's management wants to sell, but rather the opposite—that creditors may want a sale while the debtor wants to force an internal reorganization. Here the creditors will largely be stymied. Section 363(b)(1) only allows the "trustee" (or the DIP)[345] to sell property outside of the ordinary course of business.[346] Creditors have no authority to propose such a sale. Creditors could file a liquidating plan,[347] but only if the debtor's exclusive period has expired or been terminated,[348] which, as discussed above, rarely happens. The only apparent avenues of recourse are for the creditors to seek to terminate exclusivity, either directly[349] or through the appointment of a trustee,[350] or to ask for a conversion to Chapter 7 for cause under section 1112(b).[351] In practice, these remedies are rarely granted.

I would suggest giving creditors greater power to propose a substantial-asset sale. This could be accomplished in various ways, but would require some sensitivity to the normal processes of corporate governance. Section 363(b)(1) could be amended directly to extend the power to propose non-ordinary-course sales to all parties in interest, rather than just the trustee or DIP. The concern with this is that any crackpot could trigger litigation over the propriety of a sale. The presence of such a provision might deter many

343. 11 U.S.C. § 1112(a) (1988). A debtor is not entitled to convert as of right if a trustee has been appointed, *id.* § 1112(a)(1); the Chapter 11 case was originally commenced as an involuntary case, *id.* § 1112(a)(2); or the Chapter 11 case was converted from another chapter other than on the debtor's request, *id.* § 1112(a)(3).

344. *Id.* § 1112(b) (court "may" convert or dismiss the case on request of a party in interest).

345. 11 U.S.C. § 1107(a) gives the DIP all the rights and powers of the trustee.

346. *Id.* § 363(b)(1).

347. 11 U.S.C. § 1123(b)(4) allows liquidating plans.

348. *Id.* § 1121(c).

349. Under 11 U.S.C. § 1121(d) the court may shorten the exclusive period for cause.

350. Under 11 U.S.C. § 1121(c)(1) exclusivity terminates automatically upon the appointment of a trustee.

351. *Id.* § 1112(b).

debtors from ever filing Chapter 11 in the first place.

One way to address these concerns would be to restrict the power to request a major-asset sale to an official section 1102 committee. The likelihood of nuisance crackpot motions would be greatly diminished in that event. Another possibility would be to allow any party in interest to make the motion, but only after first obtaining court approval. An analogy to a derivative suit could be made.

Another possible method of opening up access to the auction process would be to limit exclusivity in some way. The merits of those suggestions were addressed above. It may be possible, however, to have different exclusivity rules depending on whether the non-debtor is proposing a liquidating or non-liquidating plan. If a liquidating plan is being proposed, then an earlier termination of exclusivity, for that limited purpose only, might be considered.

Along these lines, a further option might be to require the court at some defined point in time to consider the merits of an auction. Earlier I considered the possible benefits of a threshold feasibility determination, perhaps in conjunction with the 120-day exclusivity period. This feasibility hearing might be expanded to consider explicitly the possibility of a sale of the debtor's assets. In doing so the court should not indulge a presumption against such a sale. Indeed, if the debtor has not filed a plan by the 120-day period, it would be entirely appropriate for the court to operate on the assumption that a sale should affirmatively be pursued, subject of course to rebuttal by the debtor or other parties in interest. The U.S. Trustee could even be charged with the responsibility of appointing an independent investment banker to pursue the possibility of a sale. Nor should this feasibility/sale hearing be a one-shot thing. If the debtor's exclusive period is extended initially and the sale option blocked for the time being, a similar inquiry should be made at the conclusion of the extended period.

One objection to the scheme I have proposed is that it would compel a significant amount of unnecessary and wasteful litigation. Take, for example, a hypothetical case in which a sale is entirely impractical and no one seriously favors such a course of action. Why, in such a case, should a hearing be conducted on the merits of a sale that no one wants? Furthermore, who would even present the case for such a sale?

The latter issue applies with equal force to feasibility hearings generally. One possibility is to place responsibility for examining feasibility and for pursuing the sale option in the U.S. Trustee's office. Those offices today are probably too understaffed to adequately perform these additional responsibilities, so would have to be given the money to hire more help. Another possibility is to use the creditors' committee, which is already charged with investigating whether the debtor's business should be continued. That investigatory duty could be expanded to include a duty to report on the advisability of a sale. A third possibility is to appoint in each

case an independent investigator or examiner to consider the merits of a sale. The objection there would be the extra cost involved.

The concern with whether a hearing on a sale option should be mandatory is potentially a serious one. Yet, I believe that it can be dealt with. In an environment in which approximately ninety percent of all Chapter 11 cases fail, it is not irresponsible to suggest that the parties may not be omniscient. Whatever party is given the responsibility for considering the sale option could be required to file a preliminary report advising on the prospects of a sale. If the report indicated that a sale was not propitious at the present time, and if no one objected to that report's conclusions, then the sale part of the hearing could be handled quickly.

Another possible criticism is that the looming presence of the sale option might inhibit negotiations for an internal plan. That may well be true. However, I believe that if meaningful and promising negotiations are going forward, a court could easily find that a sale presently is not warranted. If creditors as a group feel so strongly about the benefits of a sale, as opposed to an internal reorganization, that they stonewall plan negotiations, then that may be a significant indicator that a sale should be seriously considered.

This leads to a concern that debtors may lose control over the course of a reorganization. If that prospect is serious enough, it may even chill the willingness of debtors to file for Chapter 11 in the first place. My response is that Congress never intended for debtors to have the almost absolute control over a Chapter 11 case that they now generally enjoy in practice. Earlier I talked about how exclusivity practice has largely frustrated the congressional intent that debtors and creditors should share a balance of power in a Chapter 11 proceeding. My proposal would help to restore a proper balance of power. Creditors still would have to convince the court that a sale is a good idea; they would not have plenary power to implement such a course.

M. Appoint Trustee or Examiner

Another reform idea that has been floated is to appoint either a trustee or an examiner in every case, or to pursue some lesser variant thereof.[352] Possible variants might include only making the appointment for publicly held debtors, or for debtors with a certain amount of debt, or only after the passage of a certain amount of time, and so forth. Obviously the seeds of this idea derive from the old practice under Chapter X, in which a trustee was appointed in every case with over $250,000 in contingent, liquidated indebtedness.[353] In thinking about the wisdom of mandatory trustees or

352. *See* Jones, *supra* note 5, at 1092.

353. Chandler Act, ch. 575, § 156, 92 Stat. 840, 888 (1938) (repealed 1978).

examiners, we again therefore are obligated to consider (1) why Chapter X initially was set up to provide for independent trustees in every case, and (2) why the Chapter X practice was abandoned in 1978; and then to assess the extent to which those reasons either are or are not still persuasive today.

A primary theme running throughout Chapter X was the perceived need to protect the public investor from the machinations of corporate insiders, who supposedly were reorganizing companies in cahoots with friendly bank creditors to the detriment of the "little guy."[354] The foundational document reaching this conclusion and driving the enactment of Chapter X was the Protective Committee Report,[355] published in eight parts from 1937 to 1940 under the supervision of William Douglas until his appointment to the Supreme Court. Essentially, this report concluded that many reorganizations of public companies were little more than "set-up" jobs in which the public investor got shortchanged. The medicines needed to cure this ill were first, the appointment of a disinterested trustee in every case; second, an active supervisory role for the SEC; and third, a rigid application of the absolute priority rule.[356] None of these protections was carried over into Chapter XI, where they were seen as unnecessary.

By the time of the reforms of the 1970s, many observers felt that Chapter X had outlived its usefulness, for a variety of reasons. One was the perception that the financial world Douglas that looked at in the 1930s no longer existed[357] (indeed, some of his contemporary critics suggested that it did not exist then, either).[358] For example, by the 1970s the public investor more often than not did not hold senior debt, but subordinated debt or equity. Thus, a strict absolute priority rule harmed these investors more than it hurt them.[359] Furthermore, the abuses of the 1930s now rarely occurred, given the pervasive impact of the securities laws and the powerful role of the SEC generally.[360] The need for protection of public investors by always appointing a trustee no longer seemed as compelling.

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354. *See* COMMISSION REPORT, *supra* note 74, pt. 1, at 249-51.

355. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, pts. I-VIII (1937-1940).

356. *See* COMMISSION REPORT, *supra* note 74, pt. 1, at 243-45.

357. *See* 124 CONG. REC. H11,101 (daily ed. Sept. 28, 1978); 124 CONG. REC. S17,417 (daily ed. Oct. 6, 1978); H.R. REP. NO. 595, *supra* note 2, at 222, 232-33, *reprinted in* 1978 U.S.C.C.A.N. at 6182, 6192.

358. *See* Robert Swaine, *"Democratization" of Corporate Reorganizations*, 38 COLUM. L. REV. 256, 257-58 (1938), *quoted in* COMMISSION REPORT, *supra* note 74, pt. 1, at 242-43.

359. *See* H.R. REP. NO. 595, *supra* note 2, at 222, *reprinted in* 1978 U.S.C.C.A.N. at 6182.

360. *See id.* at 232-33, *reprinted in* 1978 U.S.C.C.A.N. at 6192.

Indeed, automatic appointment of a trustee was viewed instead as imposing serious costs. The primary costs contemplated were (1) the direct expense of an independent trustee and (2) the indirect expense stemming from the displacement of existing management and the need for the new trustee to familiarize himself with the debtor's business.[361] A further negative consequence of the mandatory-trustee rule was the fact that debtors would mightily resist filing under Chapter X, where they would be replaced.[362] This of course led to widespread attempts to reorganize public companies in Chapter XI, which in turn led to enormous amounts of litigation over the chapter choice, and the deprivation for public investors of the protections of Chapter X in the vast majority of cases.[363]

Interestingly, the determination to ditch the Chapter X approach was not the product of an overwhelming consensus. Indeed, the result reached in the 1978 Code in section 1104[364] was arrived at almost grudgingly, after several modest interim steps. The 1973 Commission Report recommended, in conjunction with its proposed merger of Chapters X and XI, abolition of the mandatory trustee.[365] That was done, however, largely because of (1) a recognition that in the context of a single reorganization chapter there would be some debtors, especially those that are closely held, for whom appointment of a trustee would be foolish; and (2) the burden of operating the business in some cases would be an unwarranted one for the trustee, when the only real need was for an investigation of the debtor.[366] Yet, the Commission remained adamant that "an independent trustee is often desirable, especially in a case involving the reorganization of a corporate debtor having substantial indebtedness and publicly held securities."[367] As a result, the Commission suggested that "the need for appointment be presumptive where indebtedness exceeds $1,000,000 and there are 300 or more security holders."[368] Furthermore, the Commission scheme contemplated the creation of an independent, watchdog administrative agency to police the bankruptcy process, which could recommend to the court the need for a trustee.[369] The door was cracked open, however, by the introduction of an element of discretion vested in the bankruptcy judge as to whether to appoint a trustee.

361. *See id.* at 233, *reprinted in* 1978 U.S.C.C.A.N. at 6192.

362. *See id.* at 233-34, *reprinted in* 1978 U.S.C.C.A.N. at 6193.

363. *See id.* at 223, 232-34, *reprinted in* 1978 U.S.C.C.A.N. at 6182, 6193.

364. 11 U.S.C. § 1104 (1988).

365. COMMISSION REPORT, *supra* note 74, pt. 1, at 253.

366. *Id.*

367. *Id.* at 252.

368. *Id.* at 253.

369. *Id.*

By 1978, however, the opening in the door had been pushed a bit wider. The Senate had favored the mandatory appointment of a trustee in "public" cases, defined as ones in which the debtor had $5 million in debts and 1000 security holders.[370] The House preferred a purely discretionary approach.[371] However, the 1977 House Report still contemplated the existence of a national, independent U.S. Trustee system and postulated that the U.S. Trustee could help advise the court as to which cases were appropriate candidates for trustees. The 1978 Code itself adopted the House approach of making trustee appointment discretionary.[372] However, the U.S. Trustee system was made only a pilot program in a few districts.

The remnant of the public debtor approach was the requirement in section 1104(b)(2)—apparently mandatory[373]—that an examiner, rather than a trustee, be appointed in all cases with $5 million in unsecured debts.[374] The motivation for this change in part was the idea that the most important reason a trustee was needed was to investigate the debtor, which an examiner could do as well. An examiner, however, unlike a trustee, would not be saddled with the additional burden of having to operate the business.[375] It seemed the best of both worlds.

The 1978 blueprint has not been followed. Under the Code, trustees are almost never appointed. Although section 1104(a) is not a dead letter, it is not far from it. Courts announce and apply a very strong presumption against the appointment of a trustee. The norm is that the debtor continues in possession. This, I submit, is a perversion of what virtually everyone involved in the 1970s reforms intended. Even the mandatory-examiner provision is routinely ignored by courts. It may be that the pendulum has swung too far. The question today is whether to swing it back, and if so, how far.

In thinking about this issue, it is worth highlighting some of the reasons why the mandatory trustee idea has resurfaced. Some are legitimate; others are less so. One of the popular indictments levied against Chapter 11 today

370. S. REP. NO. 989, 95th Cong., 2d Sess. 115 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5901.

371. *See* H.R. REP. NO. 595, *supra* note 2, at 234, *reprinted in* 1978 U.S.C.C.A.N. at 6193-94.

372. 11 U.S.C. § 1104(a) (1988).

373. *Id.* § 1104(b) ("court *shall* order the appointment of an examiner"); *see* 124 CONG. REC. H11,100 (daily ed. Sept. 28, 1978) ("In order to insure that adequate investigation of the debtor is conducted to determine fraud or wrongdoing on the part of present management, an examiner *is required to be appointed* in all cases in which the debtor's fixed, liquidated, and unsecured debts . . . exceed $5 million"); 124 CONG. REC. S17,417 (daily ed. Oct. 6, 1978) (same).

374. 11 U.S.C. § 1104(b)(2).

375. *See* COMMISSION REPORT, *supra* note 74, pt. 1, at 253.

is that debtors' management are using it to feather their own nests. Indeed, one of the central conclusions of the Bradley and Rosenzweig article was that debtor management was one of the only beneficiaries of Chapter 11 today.[376] The case for appointing a trustee then would be (although Bradley & Rosenzweig do not make this assertion, because they think the better approach is just to repeal Chapter 11 outright) that Chapter 11 would not be invoked as a strategic device by debtors' managers who knew that they would thereby be putting themselves out of a job.

Furthermore, the assertion is made that this foreknowledge would have a chastening effect on the business practices and strategies of debtor companies. Another of the charges made against Chapter 11 is that it creates perverse investment incentives, in that debtors can pursue highly risky business strategies, confident that if the risk does not pay off, Chapter 11 will provide a soft and safe landing. Thus, Bradley and Rosenzweig argue that Chapter 11 is more endogenous than had previously been thought, in the sense that the reasons why debtors end up in Chapter 11 often are very much in the control of the debtor up front.[377] Without Chapter 11, they argue, debtors would have to make business planning decisions even up, without the Chapter 11 hedge. Just the same, the argument can be made that managers who know they will lose control of the company if it ends up in Chapter 11 would elect up front to pursue more cautious and prudent business plans.

One of the major problems with this argument is that it ignores the facts. The evidence shows that most chief executives of a company that ends up in Chapter 11 lose their job as a consequence, either shortly before the filing or relatively soon thereafter.[378] This evidence belies the assertion that Chapter 11 does in fact provide a safe haven for a debtor's top managers. Thus, either debtors' management are systematically ignorant of this phenomenon, or Bradley and Rosenzweig and others are wrong.

Having said that, there is no doubt that Chapter 11 often is used for somewhat questionable reasons. How questionable depends in part on one's political as well as business philosophy, but most observers concede that many debtors do push Chapter 11 to the limits. It is a fair suggestion that

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376. Bradley & Rosenzweig, *supra* note 3, at 1088.

377. *Id.* at 1047-48.

378. Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355, 356 (1990); Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 246-48 (1989); LoPucki & Whitford, *Corporate Governance*, *supra* note 9, at 723-37; LoPucki, *Strange Visions*, *supra* note 9, at 105; *see* Henwood, *supra* note 16, at 363; *Go Bust*, *supra* note 16, at 63; *Professor Lynn LoPucki: Bradley & Rosenzweig Were Wrong*, 23 Bankr. Ct. Dec. (CRR), at A5 (Oct. 29, 1992); *The NCBJ Debate: Elizabeth Warren vs. Bradley & Rosenzweig*, 23 Bankr. Ct. Dec. (CRR), at A7 (Oct. 29, 1992).

such strategic usage of Chapter 11 would be reduced, at least somewhat, if the debtor's management believed that they would be displaced, or even that they plausibly might be displaced. I believe that the top management of most companies that file for Chapter 11 do not believe that they will be replaced by a trustee. If they did think that would happen, they would perhaps be more reluctant to use Chapter 11.

Critics of the mandatory trustee approach would retort that that is exactly the rub. Not only would the illicit Chapter 11 cases be deterred, but so too would proper candidates for relief. To borrow an old maxim, it would be like "throwing the baby out with the bathwater." A mandatory system thus would "over deter" filings. But, a discretionary system, experience shows, underdeters.

There are other possible reasons why a mandatory trustee might prove beneficial. One would be to speed up the reorganization process. As discussed earlier, one of the probable causes of the lengthy delays in Chapter 11 is the fact that the debtor retains exclusivity for a virtually indefinite period, thus allowing the debtor to adopt something of a take-it-or-leave-it attitude in plan negotiations. Negotiating gives way to a waiting game. An independent trustee, however, would not have a vested interest in delaying the plan to cut a better deal for himself.

Perhaps just as importantly, a disinterested trustee probably could be more objective about the feasibility of the debtor's chances of successfully reorganizing. The current high failure rate of Chapter 11 cases suggests strongly that far too many hopeless debtors give Chapter 11 a whirl. Time and money are lost before these doomed companies are eventually liquidated and put out of their misery. An independent trustee would not have the same predisposition as entrenched management always to try to reorganize the debtor. Such a person could make an objective assessment that many of these cases should be liquidated earlier rather than later. The cost savings derived from earlier termination of these cases very well could offset the cost outlay involved in hiring a trustee.

Those who worry that Chapter 11 permits unwarranted reallocations between different categories of claimants also should have reason to favor a trustee system. The only goal of a trustee should be to maximize the value of the estate. The trustee again would not have a vested interest to push the reorganization in a direction that would favor equity or junior creditor claimants at the expense of senior claimants.

Aside from the cost concern, critics of a mandatory trustee proposal are sure to object that too many debtors, including some who could be saved in the friendly confines of Chapter 11, would be deterred from filing.[379] To

379. This concern was expressed in the 1970s as a reason for abandoning the mandatory trustee approach. *See* H.R. REP. NO. 595, *supra* note 2, at 233-34, *reprinted*

some extent that may not be altogether bad; the Chapter 11 failure rate suggests that there are far more hopeless debtors entering Chapter 11 now than there are salvageable companies who foolishly bypass an attempt at Chapter 11. In other words, if a choice has to be made between over-deterring and underdeterring Chapter 11 filings, we should adjust the law now in favor of overdeterring, because the balance now runs so heavily the other way.

If the deterrence objection is given credence, however, I have a possible compromise to suggest which may in itself have some beneficent aspects. That suggestion is to postpone the trustee appointment for some defined period of time after the Chapter 11 filing. Thus, current management would have a chance to confirm a plan, but if they did not do so expeditiously, they would be replaced. Giving debtors a chance might lessen the deterrent effect. For example, the debtor might remain as DIP for 120 days, or six months. If a plan were filed within that time, the debtor then would have another sixty days to obtain confirmation. Failing either, the trustee appointment would be automatic. This moratorium, if you want to call it that, might be drafted so as to dovetail with other "doomsday" events that I have previously discussed: the expiration of exclusivity, an evaluation of feasibility of the reorganization, an evaluation of the possibility of a sale, the restarting of the debtor's obligation to pay interest, and the like. All of these ideas would be intended (1) to provide the debtor with a real incentive to move quickly and (2) to formalize the system for assessing the feasibility of different options and allow for a termination of the case at an early stage.

A slight variation of the foregoing would be to provide for a series of steadily progressing steps if a plan is not confirmed by dates certain. For example, after the first 120 days, if no plan is confirmed, an examiner could be appointed to investigate the debtor's business, the feasibility of an internal reorganization, and the possibility of a sale. After another 120 days, the examiner's report would be made. Depending on the contents of that report and on whether the debtor had by then filed a plan, a trustee might be appointed at the 240-day mark, and exclusivity terminated. Perhaps another 120 days later the obligation to pay interest to creditors would resume.

Several objections might be made to these suggestions. One is that the whole scheme is too rigid and inflexible. Every case is different and has its own time demands, critics would charge, and the best results can be obtained from a flexible, discretionary system. In some cases it simply would be impossible to comply with the time limits, and those cases would be unnecessarily lost. One answer to this charge is that the current discretionary system is not working too well either; the error simply runs

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in 1978 U.S.C.C.A.N. at 6193.

the other way, with every case being kept alive even though the patient has long since expired. But, if this inflexibility objection really is taken to be compelling, then it might be possible to give the court the discretionary power to override the statutory time triggers. However, and I emphasize this, there is no point in going this route at all unless the courts' override power is limited to rare cases; otherwise we will be right back to where we are now. Thus, an override might be allowed upon a showing of "extremely compelling circumstances," or the like. Alternatively, the creditors' committee might be given the power to waive immediate implementation of a particular remedy, if they believed it would be contrary to the best interests of the reorganization.

Another criticism might be that some debtors by their very nature are poor candidates for a trustee, simply because the management of the debtor really constitutes the critical value of the company. This would be most true in the case of smaller, closely held debtors. Recall that only Chapter X provided for a trustee. The Commission bill of 1973 (presumptively)[380] and the Senate bill in 1978 (conclusively)[381] would have still have made a trustee/no trustee distinction based on a combination of factors relating to the amount of the debtor's debt and the extent to which the debtor is publicly held. If we are to stay with a single reorganization chapter, the reality may be that some similar type of distinction would need to be made. I would favor at least two floor tests: (1) a minimum amount of debt, to ferret out the truly small "Mom and Pop" outfits where the expense of a trustee would hardly be warranted, and the likelihood of person-specific value would be very high; and (2) the existence of a minimum number of public shareholders.

Of course, if the dual reorganization chapter approach (recall Chapter 10) is taken, that could be the dividing line. The mandatory system could be implemented in Chapter 11, with the debtor remaining in possession in Chapter 10. As discussed earlier, that would not be the course I would favor, at least for now. I think the same advantages could be realized by different rules in a single chapter.

In sum, then, I think the case can at least be made for taking a hard look at the mandatory trustee/examiner issue again. As I have suggested, many of the objections to such a system could be met by phasing in implementation in various ways and by giving the bankruptcy court a discretionary override power. The benefits, especially in terms of speeding cases up and bringing them to a quicker conclusion, could be quite significant.

380. *See* COMMISSION REPORT, *supra* note 74, pt. 1, at 253.

381. *See* S. REP. NO. 989, *supra* note 370, at 115, *reprinted in* 1978 U.S.C.C.A.N. at 5901.

VI. CONCLUSION

"Chapter 11" has become an American byword. It is an ingrained part of not only our legal landscape, but also of our popular culture (and mythology?). Yet, today, it is fashionable to heap opprobrium on Chapter 11 and to suggest either a radical reworking of Chapter 11 or its outright repeal.

Against that backdrop, in this Article I have undertaken to assess the future of Chapter 11. In doing so I have appraised the bases for the criticisms of Chapter 11, have inquired into the normative justifications for Chapter 11, and have dissected a multitude of reform proposals. On the latter score, I first analyzed the more radical proposals for replacing Chapter 11 with a mandatory auction system or with a contract-based contingent-equity scheme; both were found wanting in crucial respects. Next, I examined in some detail the merits of Chapter 10, the proposed small-business chapter. While Chapter 10 has many adherents, my own conclusion is that Chapter 10 should not be adopted; instead, satisfactory reform could be accomplished within the confines of Chapter 11. The final part of the Article looked at a dozen disparate suggestions for revamping Chapter 11 so that it might come closer to achieving its underlying purposes with a minimum expenditure of time and money. Many of these reform proposals may have merit. With Congress actively on the bankruptcy reform trail, it is quite plausible that some of the reforms discussed could become law. If a Review Commission is formed, many more of the issues are likely to receive a full airing.

Perhaps the assaults on Chapter 11 have been beneficial, in that they have forced champions of Chapter 11 to rethink and to defend their justifications for that chapter. Open and forthright debate hopefully will lead to a stronger, more effective Chapter 11. I believe that Chapter 11 does have a future—a very important future—in shaping our nation's legal and social calculus. Like it or not, Chapter 11 has become the forum in which many of our most critical and intractable problems are sorted out. For commercial enterprises, the reorganization court is the court of last resort.